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WHAT DO WE KNOW ABOUT THE POLITICAL ECONOMY OF ECONOMIC POLICY REFORM?

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The recent wave of democratization in developing countries and in formerly communist ones has sparked renewed interest in the relation between politics and economic adjustment. Adjustment programs, however well designed in a technical economic sense, are often politically difficult to launch and, once launched, to keep afloat. Success in implementing an adjustment program may depend on a government's skill in generating political support and holding off the opposition. This article explores the politics of economic reform, drawing on country studies by political scientists and country specialists, the growing theoretical literature by economists, and the findings of a World Bank research project on the political economy of adjustment in new democracies. The article examines three broad clusters of variables: institutional characteristics of the political system, aspects of the internal and external economy, and the design of the reform program. It also considers the relevance of political analysis for policymakers and for international financial institutions.

The recent wave of democratization in developing countries and in formerly socialist countries has sparked renewed interest in the politics of adjustment. Economic reforms, regardless of their aggregate effects, have distributive consequences, creating benefits for some while imposing hardship and loss on others. Whether reform succeeds and endures can thus hinge on the ability of the government to mobilize political support for the program and to manage the opposition.

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This survey explores the politics of economic reform, drawing on the literature from both economics and political science and the results of a World Bank research project on structural adjustment in new democracies (Haggard and Webb forthcoming). We examine the influence of political institutions on the adjustment process, the links between economic conditions and the politics of reform, and the way in which the design of the program influences the pattern of political support or opposition.

Political Interests and Institutions

The obstructionist influence of "vested interests" is a recurrent theme in analyses of failed reform efforts. For most policy reforms, the interests of different groups are easy to identify: the nontradable goods sector opposes devaluation, firms producing import substitutes balk at trade liberalization, farmers object to cutting agricultural subsidies. Because politicians and bureaucrats rely on interest groups for political support, votes, and money, they are sensitive to such pressures. Although highly stylized, this picture is characteristic not only of journalistic accounts, but also of the literature on rent-seeking behavior, by economists (Krueger 1974; Bhagwati 1982) and political scientists (Bates 1981; Rogowski 1990; Frieden 1991).

Despite its popularity, interest-group analysis has important limitations (D. Nelson 1988). Individuals, households, and firms occupy several positions in the economic structure simultaneously—as producers, consumers, and recipients of transfers—with interests that often do not coincide. In times of rapid economic change, people may not know in advance whether they will benefit or lose from a reform. Fernandez and Rodrik (1991) and Przeworski (1991) emphasize that such uncertainties can lead to biases in favor of the status quo: even groups that end up benefiting from the reform may not initially support it if they fear it will make them worse off. Yet, wide-reaching reforms in Spain in the late 1970s and in Poland in recent years show that interest group pressures need not block reform even in democracies. Under the right institutional conditions, astute political leaders can build new coalitions of winners that crowd out those with an interest in maintaining the status quo. Indeed, reform in a democracy could not occur otherwise (Waterbury 1989).

Authoritarian and Democratic Regimes

Any political analysis of reform demands attention to the interests at stake, but institutional factors also influence the policy process. One of the most contentious debates in comparative political economy concerns the implications of the type of political regime for reform and, more generally, for economic performance. In the 1980s numerous studies probed the relative capacity of authoritarian and democratic governments to maintain stable macroeconomic

policies or to initiate broader market-oriented reforms (Skidmore 1977; Pion-Berlin 1983; Kaufman 1979, 1985; Haggard 1986, 1990; Haggard and Kaufman 1989a, 1989b, 1990; Bienen and Gersovitz 1985; J. Nelson 1984, 1989, 1990; Remmer 1978, 1986, 1990; Siddell 1987; Snider 1990). Several lines of argument suggested that authoritarian regimes might be more successful in initiating reform than democratic ones, particularly given the weaknesses of democratic institutions in most developing countries. We find, however, that the theoretical support for this claim rests on crucial assumptions about the nature of authoritarian leadership and that the empirical evidence for the advantages of authoritarianism is inconclusive.

Why might authoritarian regimes succeed when democratic ones fail? First, rent-seeking groups may have greater influence in democracies. An influential early study of post–World War II experience in Latin America noted that democratic regimes permit the formation of alliances "in which each [element] thinks it can best protect its fortunes if stabilization is scrapped" (Skidmore 1977: 149; see also Olson 1982). Models of budgeting in democracies have shown how legislators face interest-group pressures to increase transfers to their districts (Shepsle and Weingast 1984) or to provide side payments to sustain coalition governments (Sachs and Roubini 1988). The influence of interest groups on trade policy in democracies is thoroughly documented (D. Nelson 1988). Authoritarian leaders, by contrast, can override interest-group demands by fiat.

Partly because of their ability to dominate interest groups, authoritarian governments also have longer time horizons. Many economic reforms, such as fiscal adjustment or trade liberalization, entail short-term costs while the benefits take longer to unfold. If the democratic politician cannot count on being in power long enough to reap the political gains from reform, optimal policies will be abandoned as interest-group lobbying or electoral pressures intensify. Authoritarian leaders might find it easier to take a longer-term perspective because they encounter weaker interest-group and electoral constraints.

The hypothesis that authoritarian regimes do better is not without empirical support—countries in Latin America and East Asia are often cited as examples. In a stylized sequence: weak democratic governments are unable to resist pressures to boost wages and pursue other populist but unsustainable fiscal and monetary policies. Inflation mounts and stabilization efforts founder. As the crisis deepens, the military seizes power and imposes the costs of adjustment on labor and other groups (Collier 1979). This pattern is visible in the so-called bureaucratic-authoritarian regimes in Latin America (Argentina in 1966 and 1976, Brazil in 1964, Chile in 1973, and Uruguay in 1973) and elsewhere (Indonesia in 1966 and Turkey in 1971). The developing economies of East Asia—the Republic of Korea, Taiwan, Singapore, and Hong Kong—also undertook crucial policy reforms under authoritarian or administrative auspices (Deyo 1989; Haggard 1990; Wade 1990), and China's recent reforms were undertaken

on the explicit premise that economic and political liberalization need not go hand in hand.

The model of the authoritarian regime as a boon to developmental reform has two theoretical shortcomings. First, it assumes an enlightened leadership. A rational dictator might seek to maximize the present value of consumption through policies to enhance growth or through tax increases that are inimical to growth—the "leviathan" of Findlay and Wilson (1987). The possibility of these diametrically opposed strategies of enlightened despotism and predatory behavior helps explain why economic performance seems to vary more among authoritarian governments than among democratic ones. Military governments in Latin America made policy mistakes as egregious as their democratic predecessors, and in some authoritarian countries, including Albania, Iran, Myanmar, and Romania, policies contributed to economic blight so severe that only a dictator could have sustained them.

The second difficulty concerns the assumption that authoritarian governments are immune to interest-group pressures and therefore have longer time horizons. Authoritarian governments may not be accountable to electorates, but they may nonetheless remain vulnerable to interest-group pressures. Indeed, Olson (1990) has shown how the absence of regularized turnover and political competition can give rise to corruption more pervasive and intractable than would be possible under accountable forms of rule. The Philippines under Marcos, Haiti under the Duvaliers, and Zaire under Mobutu are cases in point.

The few systematic comparisons of performance and policymaking in authoritarian and democratic regimes have yielded ambiguous results. Sirowy and Inkeles (1990) review thirteen quantitative, cross-national studies by sociologists and political scientists. They underline the indeterminacy of the findings, but note that these studies provide little support for the thesis that democracy promotes growth. Remmer (1978, 1986, 1990) finds either that the type of regime has no correlation with macroeconomic policy and performance or that democracies do better than authoritarian regimes. Recent research by economists on the importance of secure property rights also supports a positive relation between democracy and growth (Scully 1988). These studies have not always controlled for other economic and political factors that may affect performance, but more sophisticated research designs also do not find systematically better policy performance by authoritarian regimes (Haggard, Kaufman, and Webb 1991).

The ambiguity of these findings suggests that the debate should move beyond simple distinctions between authoritarian and democratic regimes to greater differentiation within each category (J. Nelson 1990). For example, Haggard and Kaufman (1992b) argue that stable two-party democracies have a better record on macroeconomic policy than do authoritarian governments but that authoritarian regimes are more likely to stabilize when inflation and social conflict are high (see also Kaufman 1986). These findings suggest, however, that optimism about the effect of democratization on economic perfor-

mance may not be warranted either. Whether economic performance improves depends very much on the nature of democratic institutions.

Transitions to and from Democratic Rule

The global wave of political liberalization and democratization since the mid-1970s has increased interest in the economic consequences of changes in regime (J. Nelson 1989, 1990; Haggard and Kaufman 1989a; Remmer 1990; Przeworski 1991). An incumbent regime that believes its days are numbered will be strongly tempted to drum up support through expansionist policies and delays of reform, even if this policy is self-defeating over the longer run. There is some empirical evidence that the political crises and stalemates that attend transitions from authoritarian to democratic regimes, and vice versa, are associated with macroeconomic instability (Haggard, Kaufman, and Webb 1991). Here we focus on the problems of transitions to democracy.

Political and economic conditions at the time of the transition have an important bearing on the ability of the new government to manage the economy. Authoritarian governments that improved economic performance through extensive and difficult reforms are better positioned to control the pace and substance of the political transition when they relinquish power; Chile in 1989 and Turkey in 1983 are examples (Haggard and Kaufman 1992c). The outgoing authoritarian leadership is also more likely to have built tacit or explicit bases of support for the new policy regime and to maintain control of the macroeconomic situation.

Many authoritarian regimes do not exit by choice, however, but rather come under pressure from popular protest, the defection of key economic elites, and internal divisions. A faltering economy seems to precipitate this type of transition. In many of the democratization experiences in Latin America, including Brazil in 1985 and Argentina in 1983, and in Poland more recently, the outgoing authoritarian leaders engaged in a last, desperate round of expansionist economic policies to shore up short-term support. Many of the economic imbalances that greeted the new democratic governments can be traced to the politically motivated actions of their predecessors.

Expectations about the policy behavior of new democratic governments may thus be somewhat contradictory. New democracies may have trouble maintaining stable macroeconomic policies and undertaking structural reforms (Haggard and Kaufman 1989a). Democratization is accompanied by an increased level of political activity, which provides the opportunity for previously repressed groups, such as labor, to press their demands. Frequently, governments respond with expansionary fiscal policies and higher wage settlements, and changed expectations then lead to higher inflation.

Transitions to democracy increase budget deficits and inflation, according to cross-section statistical evidence (Haggard, Kaufman, and Webb 1991). The evidence does not show, however, that new autocratic regimes systematically

reduce public sector deficits on coming to office, as posited by the authoritarian hypothesis outlined earlier, although inflation does typically decline. And new democracies experience more inflation for a given budget deficit than their authoritarian counterparts.

Incoming democratic governments typically enjoy a honeymoon period, when they can trade short-term economic losses against various political gains. The new government can more easily gain support for broad initiatives if the regime change occurred because of failures in economic policy (Przeworski 1991).The World Bank study on the politics of adjustment in new democracies finds several examples. The most striking is the comprehensive Polish program, initiated by a government with strong ties to the union movement. The social pact forged during the transition to democracy in Spain after 1977 also provides strong evidence that new democratic governments are more likely to succeed in initiating wide-ranging programs if they move quickly (Haggard and Webb forthcoming). By contrast, new democratic leaders in Argentina, Bolivia, and Brazil pursued more expansionist policies in their early days and delayed needed reform. When events finally forced them to adjust, the economic situation had deteriorated further, support for the government had dwindled, and its programs lacked credibility. Presidents Alfonsin of Argentina, Siles Zuazo of Bolivia, and Sarney of Brazil all left office with their economies in hyperinflation.

Electoral Cycles

A central insight of the theory of political business cycles is that timing is critical to successful reform (for reviews, see Nordhaus 1990 and Alesina 1988, 1990). Good macroeconomic and trade policies yield their payoffs gradually, but the costs of reform are borne up front. Simple models of the political business cycle thus postulate that parties in power will manipulate macroeconomic policy in the short run to maximize their electoral chances, stimulating the economy as elections approach and stabilizing immediately afterward.

Empirical evidence supporting the model has proved weak for industrial countries (Alt and Chrystal 1983: ch. 5; Alt 1985; Alesina 1988). Incumbent governments and opposition parties pitch their appeals to different segments of the electorate rather than choosing policies opportunistically to maximize the probability of election. The model has also been criticized on theoretical grounds, particularly the assumption that voters are myopic about the future consequences of electorally motivated policy. According to one succinct critic, the model assumes "a collection of rogues competing for the favors of a larger collection of dupes" (Barry 1985: 300). If voters anticipate the effects of expansionary policies and of postelection stabilization measures, efforts to manipulate macroeconomic policy in the short run should have no political or economic effect, and politicians would have no incentive to attempt such policies. The political cycle disappears.

But perhaps not in developing countries. As Rogoff and Sibert (1988) and Rogoff (1990) have demonstrated theoretically, informational asymmetries between a government and its citizens can generate a political business cycle, even if voters are assumed to behave rationally. Developing countries lack many of the institutional factors—such as independent media coverage of economic policy or histories of electoral experience—that allow voters to keep the opportunism of politicians in check. And in some developing countries, where poverty is extensive and welfare systems to cushion the costs of economic crisis are inadequate, voters may be more concerned with the short run. Under such conditions, they might support governments that deliver short-term material benefits, even at the expense of long-run welfare.

The one published cross-national study of the electoral cycle in developing countries, Ames's (1987) study of Latin America from 1947 to 1982, did find significant effects of electoral cycles. Comparative case studies by Joan Nelson and her colleagues (1990) also found some evidence of policy cycles tied to elections. An analysis with a broader sample of countries that controlled for other political variables, however, found no significant difference in the level of fiscal deficits or inflation in the year of the election, the year before, or the year after (Haggard, Kaufman, and Webb 1991).

Yet these findings on actual economic performance do not necessarily contradict the obvious intuition that reforms are more difficult to initiate before an election than immediately after. In middle-income countries with high inflation, the probability that a government will undertake a stabilization program declines significantly in election years and the preceding year (Haggard, Kaufman, and Webb 1991).

Partisan Orientation . . .

An alternative to the electoral cycle approach for exploring how elections influence macroeconomic policymaking focuses on the effects of partisan differences.[1] Such models assume that parties have macroeconomic policy preferences that reflect the material interests of their constituencies. Parties on the left appeal to labor, emphasize employment over inflation, and prefer taxation of capital; parties on the right have the opposite preferences. Pioneered by Hibbs (1977), this model has been tested empirically and refined theoretically for industrial countries by Alt (1985), Alesina (1987, 1988), and Alesina and Drazen (1991).

There is only scattered evidence from developing countries on how party orientation might affect policymaking, in part because the simple distinction between left and right—useful in understanding political cleavages in industrial countries—does not easily fit the developing world. A growing body of work describes a common pattern of economic policies associated with so-called populist governments. These governments typically come to power in countries with sharp social inequities after periods of wage control and, often, political

repression as well (Sachs 1989; Dornbusch and Edwards 1989, 1992). Populist governments seek to redress these problems through macroeconomic and structural policies intended to shift income to their core constituencies in the popular sector: a broad coalition of urban middle- and working-class groups, the informal sector, and the poor. As these heterodox experiments face mounting inflation and external imbalances, however, governments are forced to introduce stabilization measures, usually at high cost to the groups they were supposed to represent. Peru under Alan Garcia provides a classic example.

. . . *And the Party System*

A finding that emerges strongly from the comparative study of new democracies is the importance of the party system in organizing support for or opposition to reform. Dominant parties capable of ruling by themselves (and in presidential systems, presidents and legislatures of the same party) have the easiest time securing legislative support for their programs. Coalition governments fare less well, and minority governments and presidential systems in which the president and legislature are of different parties have the greatest difficulty. In general, fragmented party systems encourage bidding wars among contending political forces, make legislative support difficult to mobilize and ruling coalitions hard to sustain, and contribute to political instability (Haggard and Webb forthcoming).

Mexico provides an interesting example of the strong party case. Despite some political liberalization since the mid-1970s, Mexico's political system remains dominated by a powerful single party, the Partido Revolucionario Institucional (PRI), which has long controlled, co-opted, and reconciled contending social interests. The PRI's long-standing corporatist links with labor and the private sector were crucial elements in the president's ability to secure agreement and compliance with the heterodox stabilization program contained in the Solidarity Pact of 1989 (Kaufman, Bazdresch, and Heredia forthcoming).

In Poland major reforms were launched quickly when Solidarity constituted a broad movement with widespread support. Political difficulties with the program can be traced to the emergence of a highly fragmented party system, beginning in the summer of 1990. New groups challenged the program, and the proliferation of small, weak parties made governance substantially more complicated. In Spain after 1975, events unfolded in the opposite direction. The first post-transition government of the center-right (1977–82) had difficulty getting its program through the legislature because of its minority status. Disputes within the ruling coalition contributed to ministerial turnover. By contrast, the first socialist government (1982–86), with an absolute majority in the legislature, did not have to rely on coalition partners and faced little organized opposition. This dominance allowed it to push through a more comprehensive program than that of its predecessor (Bermeo and Garcia Duran forthcoming).

That the party system is important to cohesive economic policy is not simply an academic observation. Outgoing authoritarian leaders have openly altered electoral rules and party registration laws to extend their control into the next administration. Experiences in Turkey and Chile show how this can happen. In Turkey the political and economic difficulties of the late 1970s were attributed to an increasingly polarized and fragmented political system. The military-controlled election of 1983 was limited to three parties approved by the military. As the party system subsequently opened up, the constitution was amended, with electoral rules and thresholds designed to eliminate smaller parties from participating. The rules served as intended, providing a center-right, pro-reform party with a legislative majority in 1987, although it had received far less than a majority of the popular vote. The election of 1991 once again brought a coalition government to power, however, which would suggest greater difficulty in economic management than had been the case in the early post-transition period. Democratization in Chile took a different route, but Chile's experience shows how outgoing military regimes can control the transition. Pinochet was defeated in the presidential election of 1989 by a coalition of opposition parties, the Concertación. Before the transition, however, Pinochet had already established what Arriagada and Graham call "authoritarian enclaves" in the new democratic order. Pinochet directly appointed a number of senators and oversaw changes in the electoral rules designed to guarantee "adequate" legislative representation for the right.

Perhaps the most interesting experiment in shaping the party system is occurring in Nigeria. The Babangida government, seeking to avoid ethnic polarization and to circumvent traditional party politicians, announced that only two parties would be allowed to contest the transitional elections scheduled for 1992. Moreover, the government mandated that the platforms of both parties explicitly support the structural adjustment program. As the election date drew near, the government still considered the range of political discourse too broad. The election was postponed until 1993, with the added stipulation that none of the candidates who had stood in the aborted 1992 election could run again.

Governance and the Bureaucracy

The wide variation in the quality of economic policy within both democratic and authoritarian governments suggests that the prospects for policy reform also depend on characteristics of the state itself, particularly the discipline and competence of the bureaucracy (Callaghy 1989). Consequently, many structural adjustment programs require a selective strengthening of the government's role in the economy rather than a simple reduction in government intervention (Levy 1990).

An array of administrative and organizational factors contribute to the capacity of a government to function well. Among them are the efficiency with

which information is collected, decisionmaking is organized, and tasks are allocated among implementing agencies; the quality of personnel; and the integrity and transparency of the financial workings of government, including audit and review functions. Administrative reforms in these areas are clearly important for strengthening the capacity of the state over the long run.

Being able to function efficiently is not simply a matter of administrative competence, however; reform programs must also consider the milieu in which the bureaucracy operates. Pervasive corruption can make the bureaucracy itself a powerful and well-positioned interest group, aligned against reform and capable of obstructing the implementation of adjustment programs. Even in the absence of corruption, bureaucracies are subject to interference from politicians as well. A proper system of delegation is often the solution. No modern political system, including democratic ones, can function without some degree of delegation. Politicians can have an interest in transferring tasks and protecting the autonomy of the bureaucracy. Because the effectiveness of policies depends on the widespread belief that they will be sustained, politicians can fortify their commitment by delegating decisionmaking authority to autonomous institutions. This reduces the capacity to reverse their decisions in response to short-term considerations. A growing literature on central banks, for example, suggests that institutional mechanisms that permit greater autonomy of the central bank from the government have beneficial effects on inflation and real growth (Cukierman 1992; Cukierman, Webb, and Neyapti 1992; Alesina and Summers forthcoming; Grilli, Masciandaro and Tabellini 1992; Cukierman, Kalaitzidakis, Summers, and Webb forthcoming).

Developing a bureaucratic apparatus that is reasonably well insulated from corruption and political power typically requires more than short-term reform efforts. Socialization to professional norms and institutional reform are usually long-term processes (Evans 1992). But the incentives for corruption can be reduced through attention to institutional design. For example, one justification for a policy based on rules rather than discretion is to eliminate altogether agencies with discretionary powers that can serve as the locus for rent-seeking relations between the private sector and the government.

Economic Conditions

Economic conditions influence not only the policy agenda, but also the political actions of organized social groups and thus politicians' calculations about what can and what cannot be done. Three factors are especially relevant: the intensity and length of the economic crisis, the outcomes of previous reforms (or perceptions about those outcomes), and the distribution of income. External economic and political constraints also affect the adoption and implementation of programs.

Intensity of the Crisis

It seems intuitively obvious that crises trigger reform efforts (Webb and Shariff 1992). Crises increase a government's willingness to attempt remedial measures and the public's tolerance for them. Under democratic regimes, crises are likely to bring to office new governments with new programs. Economic crises also influence the balance of power among groups and the configuration of political interests by weakening some groups and strengthening others.

If the right groups are strengthened, support for reform may gather momentum. For example, the real devaluations associated with the debt crises in Chile, Mexico, and Turkey in the 1980s boosted the profitability of export-oriented activities, and those who stood to benefit developed into an important base of support for reformist governments. The same effect is possible if crises weaken the influence of obstructionist interests. A fiscal crisis can diminish the power of revenue-seeking groups and thereby serve as an impetus to reform. Waterbury's (1992) analysis of efforts to reform state-owned enterprises shows how countries experiencing profound fiscal dislocations, such as Mexico and Turkey, experimented with more radical reform of state enterprises than countries that avoided crisis in the 1980s, such as Egypt and India.

Despite these appeals to conventional wisdom, the concept of crisis is much more elusive than first appears. Governments respond differently even to balance of payments difficulties, the most strictly binding of constraints. Countries may ultimately adjust their current account by cutting back on imports, but they do not necessarily follow up with an appropriate policy response. Not all countries recognize the same crises, and no theory has yet identified a crisis threshold that all nations would recognize. At various points in the 1980s, the Thai, Colombian, and Indonesian governments responded preemptively to warning signals and undertook important economic adjustments before economic difficulties slipped into crisis. At the other end of the response continuum are several African countries—Ghana is perhaps the worst example—that experienced full-blown economic disasters year after year but failed to deal with them effectively. When the Rawlings administration finally seized power, it was certainly responding to a crisis; but this begs the question of why no action had been taken two or five or ten years earlier.

A crisis in no way guarantees that any remedial actions taken will be sustained or institutionalized. As the crisis winds down, the urgency of reform lessens and the political forces resistant to reform typically revive. The outcome can be a cycle of policy deterioration, economic crisis, temporary or partial policy reform, recovery, and relapse. Although no one has developed a theory that fully explains such cycles, their existence is recognized in several studies on the political economy of adjustment (Krueger 1980; Webb 1988; Dornbusch and Edwards 1989; Kiguel and Liviatan 1990; Fernandez and Rodrik 1991; Ranis and Mahmood 1992; Przeworski 1991).

Any analysis of the role of crisis in policy reform must pay close attention to the perceptions of politicians and policymakers about the economic difficulties they face. Joan Nelson has suggested, for example, that politicians and policymakers are less likely to take vigorous action if they attribute the conditions that constitute a crisis to external causes or consider them to be self-correcting. Her ultimate conclusion from a study of thirteen countries, however, is agnostic: "The nature of the crisis itself—its sudden or gradual emergence, its largely exogenous or substantially internal causes, even its severity—has little clear relation to the timing of policy response in many of our cases" (Nelson 1990: 325–26)

Collective Memory—Instructive and Selective

Years after any traces of a direct effect on the economy have faded, economic successes or failures of the past continue to mold politicians' views on policy reform. Economic experiences—whether "golden ages" or "nightmares"—provide elites with lessons and analogies that shape their current decisionmaking, however different the conditions. Not surprisingly, the policy decisions that spring from these influences are often questionable. For instance, in the 1920s and again in the 1950s, the British government sought to restore the prewar exchange rate, in part because policymakers associated a strong pound with prosperity. Such misapplied lessons of history are then institutionalized in policy routines or in organizational arrangements that have a persistent influence on policy.

A more positive example concerns countries that have experienced episodes of hyperinflation. West German interpretations of interwar history typically attach great importance to fiscal deficits and hyperinflation as causes not only of severe economic distress but also of the rise of fascism. Thus, West Germans tend to view price stability as a more important policy objective than full employment, even though Germany also suffered from extraordinarily high unemployment rates between the two world wars. These perceptions of cause and effect had a profound influence on postwar economic policy and institutions, such as the independence of the Bundesbank. East German leaders, by contrast, played up memories of unemployment to justify taking an anticapitalist route. In Taiwan, as in West Germany, the establishment of a strong and independent central bank was influenced by the country's experience with hyperinflation. Indonesia's fiscal policy has been bounded by a balanced budget rule since the high inflation of the 1960s. The outgoing military regime in Chile—which had taken office amid a burst of four-digit inflation—was able to gain support from the incoming opposition government for measures to increase the central bank's independence.

The institutionalization of import-substituting policies in Latin American countries following World War II similarly owed much to interpretations of past events. The policies grew out of the memory of the international environ-

ment between the wars and the mistaken belief that short-term declines in commodity prices in the 1950s represented a secular trend. The policies had an enduring influence, in part because policymaking institutions, such as those concerned with trade and industrial policy, grew up around them and provided political access for groups that stood to gain from import-substituting activities (Sikkink 1990). Reducing the influence of such muddled legacies often requires not only changes in polices, but also institutional changes that reduce the incentives and possibilities for the undesirable policy to reemerge.

Income Distribution

A third economic factor that affects the success of policy reforms is the distribution of income (Berg and Sachs 1988; Boeninger 1991). 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, producing such undesirable economic outcomes as tax evasion, capital flight, investment strikes, and unreasonable wage demands.

When income distribution is seriously imbalanced, agreement on any package of major reforms will be complicated by considerations of whether to broaden the reforms to include a redistribution of income or even of assets. Alesina and Tabellini (1988), for example, develop a model in which greater inequality leads to polarization of contending parties, undermining the cooperation required to sustain macroeconomic stability. Berg and Sachs (1988) find that income inequality increases the probability of default on debt, and Sachs (1989) finds that it increases the proclivity to follow counterproductive populist policies. These findings underline the importance of compensatory policies in the adjustment process and thus in program design.

External Influences

The influence of external economic and political factors on domestic policymaking in developing countries has been a subject of contentious debate for decades. Building on the structuralist economic arguments of Prebisch and Singer and a Marxist sociology, a wide-ranging literature has emerged on the (generally pernicious) role of external influences on economic development.

In a review of this literature, Stallings (1992) notes that there are at least three channels through which the external milieu might influence policy choice. First, cycles of prices and demand can influence the propensity for reform. Ranis and Mahmood (1992) expanded this line of thinking, arguing that policy changes in developing countries can be traced to fluctuations in world prices of primary products and to business cycles in industrial countries. Shifts to more outward-oriented development strategies are more likely during the

boom phase of the cycle, when external conditions favor export diversification. Returns to more inward-looking strategies recur during the down phase. Although there appears to be some evidence of this kind of cycle in the past in Latin America, the current wave of reform contradicts the argument: external shocks have pushed several countries toward liberalizing reform.

Second, policy choices are influenced by international networks and socialization that result in the transmission of policy-relevant knowledge (Kahler 1990, 1992; Hall 1990; Drake 1989; Sikkink 1990). These networks include foreign advisers, training programs for technocrats at foreign universities, government-sponsored exchange programs, and work experience in multinational corporations.

Finally, external actors seek to influence policy more directly through loan conditionality (the subject of a rapidly growing literature; see Dell 1981; Williamson 1983; Killick and associates 1984; Fishlow 1990; Kahler 1990, 1992; Polak 1991; Mosley 1987; Berg and Batchelder 1985; Haggard 1986; Remmer 1986). Mosley, Harrigan, and Toye (1991: ch. 3) portray conditionality as a bargaining game with several steps. The international financial institutions may have leverage at the outset, when the government's need of support is urgent, but the success of the program depends on its implementation. As Putnam (1988) has argued most clearly, implementation of the agreement struck internationally is always contingent on domestic political negotiation or ratification. And that brings into play the types of political factors described in this article.

At the center of the debate about the politics of conditionality—to be distinguished from the economic issue of whether programs will have the desired effects—is the extent to which outside agencies actually influence the policy process. On the one hand, unity among creditors and their power over the flow of financial resources provide them with substantial influence. Extra external resources can increase the political sustainability of reforms by allowing the country more consumption while sustaining higher levels of investment. In that way, external support can lengthen the time horizons of politicians.[2] There are cases in which the lack of such external support—or, more extreme, the demand for resources through debt repayment—weakened the political position of reform advocates (Berg and Sachs 1988; Kaufman 1986; Maxfield 1990; Webb 1988, 1989).

Kahler (1992), on the other hand, argues forcefully that because of several peculiar features of international credit markets and the conditionality bargain, this received wisdom about external influence should not be taken for granted. For one thing, creditor governments, the potential enforcers of these agreements, have multiple and conflicting goals with respect to debtors. The concern to support a strategically important client can easily override the interest in enforcing conditionality. Where leaders are already committed to a reform program, as in Turkey in the mid and early 1980s, additional finance may help it succeed, although usually by supporting efforts that would have been under-

taken anyway. But when nonconditional resources are made available to countries disposed against reform, such as the Philippines under Marcos or Zaire under Mobutu, the additional finance creates perverse incentives, allowing governments to postpone adjustment.

Some strategic problems arise from attempts to impose external conditions in a system with critical informational asymmetries, difficulties in effective monitoring, and no overarching enforcer of contracts (Crawford 1987). Debtor governments seek to maximize available finance, minimize servicing costs, and smooth the domestic political and economic costs of implementing reforms. Creditors seek the opposite: a minimum of finance in return for broad and swift adjustments. Debtors have an incentive to exaggerate the difficulty of undertaking reforms and to seek support for reforms they would have undertaken anyway.

Closer monitoring, splitting up loan disbursements, and insisting that some reform take place before loan disbursement or even negotiation—such changes in the operations of the international financial institutions during the 1980s can be viewed as efforts to overcome such strategic dilemmas. The adoption of reform measures before external support is secured is usually a reliable sign that reform programs will be implemented. Kahler (1992) argues that governments committed to policy reform will probably undertake them in any case and that those opposed will resist. Similarly, World Bank (1988, 1990, 1992) reports on adjustment lending have concluded that in the absence of firm and open government commitment, lending can undermine rather than fortify reform efforts. The reports nonetheless recognize that in many cases the provision of external resources with attached conditions helps pro-reform groups within the government prevail against anti-reform groups.

The empirical evidence appears to support these expectations, although all studies in this vein note methodological problems of determining compliance. Haggard's (1986) survey of IMF Extended Fund Facility programs finds a high level of noncompliance and program cancellation due to domestic political factors. Kahler (1992) finds that during the 1980s, in only nine of nineteen cases examined had the governments implemented coherent stabilization programs, and in only five were structural adjustment programs sustained. In an intensive study of nine countries receiving World Bank structural adjustment loans, Mosely, Harrigan, and Toye (1991) find that only Thailand and Turkey actually met more than two-thirds of what the authors considered key conditions attached to the loans. Ghana, Jamaica, Malawi, and the Philippines implemented between 55 and 63 percent of conditions, and Ecuador, Guyana, and Kenya less than 38 percent. The World Bank (1990, 1992) and other studies (Williamson 1990) suggest that compliance has improved and that the range of variation may have narrowed somewhat over time. However, in a study of IMF programs in Latin America in the postwar period, Remmer (1986: 21) concludes that "the power of the IMF remains a useful myth for governments seeking a scapegoat to explain difficult economic conditions associated with severe

balance of payments disequilibria, but the ability of the IMF to impose programs from the outside is distinctly limited."

Design of the Program

Policymakers undertaking economic reform rarely have much influence over the political structure or fundamental economic situation of a country, but they have considerable control over the design and tactics of reform. Yet the optimal political design of programs is only beginning to receive attention (Przeworski 1991). A starting point is the observation that economic reform must be viewed as an exercise in coalition-building (Waterbury 1989). From a long-term perspective, the social benefits of reform outweigh the costs. The political issue is whether adequate mechanisms exist to marshal support among winners and to neutralize or compensate losers within a time frame that is relevant to a politician.

These observations suggest several hypotheses about the conditions for effective reform. Initiatives are more likely to succeed if governments, particularly the implementing agencies, are somewhat insulated from interest-group pressures. We have already explored some of the conditions conducive to such autonomy, including the type of regime, timing relative to the electoral cycle, and the nature of the bureaucracy. Over the longer run, however, consolidating reform requires building and institutionalizing a new base of political support among emerging winners. So the crucial transition is from an initial position of autonomy (usually temporary), when supporters of the status quo are politically weakened, to a new equilibrium that consolidates the new bases of support that have emerged. We consider here three elements of program design that might affect this transition path: how quickly the program is initiated, in what order the reforms are introduced, and whether and how losers are compensated.

Tortoise or Hare

Economic conditions or the nature of the reforms may give policymakers little leeway about how to pace the reforms. Hyperinflation or the depletion of foreign exchange reserves usually stimulates some immediate response. In general, the economically optimal speed for exchange rate correction, stabilization, and most domestic price reforms is as fast as is technically feasible. Delay has high economic costs and casts doubt on the sincerity of the reform effort. Privatization, financial sector reform, and trade liberalization may take longer to implement because complementary institutional changes are needed to make these policy adjustments effective.

Most, but not all, political considerations support the argument for moving quickly. The way speed affects the political balance between winners and losers argues for rapid reform. Often, the fate of a reform program depends on the

emergence of new beneficiaries to support it. A necessary, although not sufficient, condition for that to happen is rapid implementation, a condition that holds even in democracies. As Przeworski (1991: 174) argues, "radical programs are more likely to advance reforms further under democratic conditions even if most voters would have preferred to start with a more gradual strategy." Pushing reforms rapidly through the system can also weaken interest groups that are tied to the status quo and give antireform forces little time to mobilize (Douglas 1990). This positive dynamic of rapid reform is evident in Israel's stabilization in 1985, Korea's reforms in 1964–65, Turkey's exchange rate and trade reforms in 1980 (Bruno and Piterman 1987; Haggard 1990; Celasun and Rodrik 1989), and more controversially in Poland in 1989–90 (Johnson and Kowalska forthcoming).

Putting reforms in place quickly at the beginning of a new administration also means that the reforms have time to put down strong roots during the honeymoon period, when support is high and opposition muted. A new government that takes office in the middle of a severe crisis and acts immediately can blame the decline in living standards on actions of the previous government. The longer the government delays, the more likely that the costs of adjustment will be attributed to the current government, increasing the level of opposition. New democratic governments taking over from authoritarian regimes are in especially good position to trade political gains against short-term economic losses. Spain in the late 1970s and Eastern Europe in recent years demonstrate this pattern.

Yet another argument for speedy reform rests on credibility. A government that acts without delay strengthens the public's belief that the reform will be maintained steadfastly over time (Calvo 1989; Froot 1988; van Wijnbergen 1985; Przeworski 1991; Cukierman and Liviatan 1992). Rodrik (1989), for example, develops a model in which uncertainty on the part of economic agents about the government's future intentions affects investment behavior. He shows that a reform-minded government could signal the seriousness of its commitment by overshooting—by initiating reforms of a magnitude or at a pace that an uncommitted government would never attempt. When a program is implemented slowly, confidence in it deteriorates as anticipated benefits fail to emerge. The government retreats with its credibility diminished and in the next round must take even bolder action to signal its commitment. But even this bold approach is likely to be unconvincing, thanks to the legacy of past failures. This cycle is visible in the experience of several of the high-inflation countries in Latin America in recent years, including Argentina and Brazil.

Concerns about credibility can also support a more gradual approach. Rapid adjustments tend to provoke resistance because they are more unsettling and have higher short-run costs. Riots in response to rapid price reforms are typically cited as a cost of moving too quickly (but see Bienen and Gersovitz 1985 for another view). Because firms and households can shift into new activities only with a lag after a program is put in place, shock programs face the hurdle

of getting through an extended period of extremely limited support, because the economy has not yet responded. Going slow limits the initial costs and allows some of the front-end benefits to unfold and attract supporters before the next round of reform measures hits. This go-easy strategy seems more applicable to certain types of structural realignments than it does to macroeconomic policy, though, and has worked best in countries where macroeconomic imbalances are not severe, such as China, Indonesia, and Thailand (Doner and Laothamathas forthcoming; McMillan and Naughton 1992).

Phased or Bundled

Closely related to the pace of reform is its sequencing: whether reforms should be undertaken in stages or all at once. The lesson drawn from the experiences of the Southern Cone countries of Latin America in the 1970s is to stabilize the economy first. Recently, however, there has been greater recognition that combining trade reforms and macroeconomic reforms can increase confidence in the government's commitment to macroeconomic reform when it has a record of failing to follow through. Thus, economic considerations may not dictate a clearly superior sequence, giving political considerations a role.

Rodrik (1992) advances the idea that the political attractiveness of reforms depends on the ratio of the gain in output to the amount of redistribution. Trade reforms generally have a low ratio of efficiency gain to redistribution, macroeconomic policy reforms a high ratio. By packaging these reforms together, Rodrik argues, the gains from macroeconomic policy reform can offset the distributive costs of trade liberalization. This may help explain the large number of successful trade liberalization programs that developing countries undertook during periods of macroeconomic crisis in the 1980s.

The World Bank study on economic adjustment in new democracies finds that the strategy of bundling reforms has an additional advantage for relations with the private sector (Haggard and Webb forthcoming). In general, stabilization and structural adjustment offer mixed results for private sector groups, which are likely to gain from some aspects of adjustment and to lose from others. Bundling reforms allows a government to offset the losses associated with one component of the program with the gains from another—a form of compensation.

Compensation

The political argument for compensation has been cast in normative as well as positive terms. Governments may have clear moral reasons for assisting the poor. It has also been argued that compensation may be necessary to secure political support for reform—or at least acquiescence. This argument was

advanced by the well-known UNESCO study *Adjustment with a Human Face,* which defended compensatory programs for the poor (Cornia, Jolly, and Stewart 1987).

There are three possible counterarguments to compensation. First, a country simply may not have the funds to compensate losers; this has been a recurrent theme in the literature on poverty alleviation during adjustment and an important argument for adequate external assistance (World Bank 1990). Second, some types of compensatory measures may undermine the reform. Compensating workers for a nominal devaluation by increasing wages directly undermines the objective of increasing competitiveness. And third, the likely recipients of politically motivated compensation may not be the poor (Nelson 1992). The UNICEF study assumes that the poor are a politically significant group in resisting adjustment, but this is not typically the case. The greatest political threat to stabilization and adjustment programs are urban groups, including organized labor and the business sector generally. Compensating these groups may be difficult to justify, however, and may undermine the effectiveness of the program.

The studies in the World Bank project generally found, however, that some sort of compensation was crucial for securing support for programs (Haggard and Webb forthcoming). In the more successful cases—Chile, Mexico, Spain, and Thailand—compensation came in the form of complementary reforms, measures that provided effective compensation and enhanced welfare and economic opportunity over the longer term while minimizing inefficiencies. Typically, these measures did not include *direct* compensation schemes for losing groups.

If the optimal program economically is also the most effective program politically, the criteria for politically effective compensation should parallel those for economically effective compensation. In particular, compensation should seek to ease rather than reduce the reallocation of labor and capital in line with movements in relative prices.

The Concertación in Chile and the socialists in Spain (1982) came to power expecting to protect the interests of labor and the poor. Realizing that wage increases and direct subsidies would derail needed fiscal adjustments, they instead took measures to improve the distribution of health and education services and to widen the social safety net for the poor. International agreements with the United States and Europe to increase export opportunities helped compensate firms in Chile, Mexico, Poland, Spain, and Turkey that were accustomed to selling in protected domestic markets. So did export incentives in Thailand and Turkey, which accelerated the growth of exports and the expansion of pro-adjustment export interests.

The political effects of more direct compensation efforts proved unclear. In Turkey, organized labor and agriculture were the groups most hurt by the adjustment in the early and mid-1980s. As the expansion of democracy in the late 1980s brought these groups back into the political process, the government tried to compensate them for previous losses and win their support through

generous increases in wages and farm price supports. Wage increases in the private sector were justified by productivity growth and were coming about through market forces, especially after the rights of unions to organize and strike were reinstated. Direct government spending for wages and subsidies not only contributed substantially to the deterioration of the fiscal balance but still did not result in any political gain; labor and agriculture voted mostly for the opposition parties that won in the 1991 elections.

Direct compensation schemes worked well economically in Chile because they were well targeted, but they certainly did not win support for the Pinochet government or for the adjustment program. The schemes did work politically for the Concertación, because of the agreements that underlay the transition to democracy. Labor and the rural poor were core constituencies of the Concertacion parties and knew that their interests would be addressed in the long term. Similarly, the close relationship between the socialist government in Spain and the labor movement allowed the ruling party to use limited welfare measures to win political support.

The evidence from the case studies points to the conclusion that compensation measures are usually necessary to sustain political support for adjustment. But they succeed neither economically nor politically if they offer incentives contrary to the overall thrust of the program.

Is Political Economy Analysis Relevant for Policymaking?

Prescriptive policy analysis by economists aims to identify measures that are optimal according to such criteria as efficiency, stability, or growth. Positive political analysis, however, is often concerned with why optimal policies are not adopted. The findings of political analysis involve parameters that cannot be manipulated in either the short or the long run. What practical use is it, for example, to point out that inflation or trade policy are the result of the underlying social structure or the fragmentation of the political system?

Political analysis of economic policy can be of practical use in at least three ways. One is by taking into account the likely political fallout of a program when the program is being designed. An example is the need to complement the speedy initiation of a program with the right compensatory mechanisms to build support and blunt opposition. A second area is the design of institutions and decisionmaking processes within government. Some of the difficult problems of collective action, such as reconciling spending and revenue decisions, have to do with organizational features of the government that are amenable to change. Surprisingly little systematic work has been undertaken on how the organization of decisionmaking is likely to affect the success of adjustment efforts.

The final insight of the new political economy concerns the timing and content of conditionality. A program that raises expectations, engenders domestic hostility to external agencies, but is doomed to failure for political reasons can

be worse than no program at all. Ill-timed external assistance can allow governments to continue misguided policies. Political economy has not yet devised a clear set of guidelines for making judgments about the wisdom of lending by the international financial institutions, but it can help sensitize these agencies to the likely outcomes of their efforts.

Notes

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1. No one has yet systematically considered how party orientation would affect trade policy. How parties on the right and left align on the subjects of free-trade and protectionism seems to depend on other country-specific factors, such as the openness of the economy and international competitiveness of national business.

2. Evidence from the 1980s suggests, however, that countries receiving substantial adjustment lending from the World Bank did better at sustaining consumption than investment (World Bank 1990, 1992).

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