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PRINCIPLES OF POLICY FOR THE ADAPTIVE ECONOMY

Tony Killick

**Results of ODI research presented in preliminary form
for discussion and critical comment**

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WORKING PAPER 32

**PRINCIPLES OF POLICY
FOR THE ADAPTIVE ECONOMY**

Tony Killick

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Preface and acknowledgements

ODI Working Papers present in preliminary form work resulting from research undertaken under the auspices of the Institute. Views expressed are those of the authors and do not necessarily reflect the views of ODI. Comments are welcomed and should be addressed directly to the author.

This Working Paper is one of a series of draft chapters of a book currently under preparation by Tony Killick with the provisional title of The Adaptive Economy: Adjustment Policies in Low-income Countries. The purpose of this volume will be to discuss general principles of policies for what has become known as 'structural adjustment' and to set these in the context of longer-term economic development. Those who make or seek to influence policy are the chief target audience, although it is hoped that this work will also be useful for students and other members of the academic community. The complete set of papers to be issued in this series is as follows:

- 31 Economic development and the adaptive economy
- 32 Principles of policy for the adaptive economy
- 33 Exchange rates and structural adaptation
- 34 Markets and governments in agricultural and industrial adjustment
- 35 Financial sector policies in the adaptive economy (provisional, forthcoming)
- 36 Problems and limitations of adjustment policies (provisional, forthcoming)

The author is Senior Research Fellow of ODI and Visiting Professor of the University of Surrey. Thanks are due to the Economic Development Institute of the World Bank for financial support for this project but the author alone is responsible for any views expressed. Thanks are also due to Matthew Martin for valuable assistance in preparing this paper.

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I. INTRODUCTION

Working Paper No. 31 established a number of the characteristics that make for a flexible economy, one that is well able to adjust to changing circumstances and to take advantage of arising opportunities. To nurture such characteristics can thus be described as one of the chief objectives of adjustment policies. It was suggested, for example, that rising saving and investment ratios, industrialisation and financial deepening had the character of being 'enabling' types of structural change, permitting and encouraging a rate of development that otherwise would be frustrated. Information flows and the development of human skills and of enterprise were viewed in a similar light, as facilitating adaptation. The importance for the responsiveness of the economy of efficiently working markets for the factors of production, and for goods and services, was also emphasised. The particular seriousness of the foreign exchange constraint was similarly stressed. The potentially costly nature of economic adjustments was also described, with the implication that one of the government's tasks is to minimise these.

Mention was also made, however, of government policies that actually hamper flexibility, so that some have written of the necessity to adjust from a wrong set of policies, and of the consequences of policy mistakes as a kind of domestic 'shock'. The task of this Working Paper and the next in the series is to explore ways in which policy can be made part of the solution, rather than part of the problem: how mistakes can be corrected, how policies can promote adaptation.

Working Paper No. 33 takes a detailed look at some specific adjustment policies, while this one is chiefly about the general principles of policy. We start with a discussion of the overall role of the state in the adaptive economy, relative to the private sector, and the principles that might be employed in approaching this issue. We then proceed to the strategy choices that present themselves to governments when deciding the general thrust of their approach, following this with a more specific discussion based on an illustrative matrix of policy goals and instruments.

This leads on to consideration of the general principles of policy: the notion of tradeoffs; the criteria that might be employed in deciding which policies to deploy; how policies interact among themselves, and with the economy, as a system; and questions concerning the implementation and sustainability of adjustment policies. We conclude with cautionary words about the nature of the state as an economic agent; about the danger of disproportion between the seriousness of the problems and the power of the available policy instruments; and about external finance.

II. APPROACHING THE ROLE OF THE STATE

There has in recent times been some ferment in economics about the role of the state in economic life.¹ Many now take a more sceptical view of what the state can - or should - do, and this change has in turn fed into the 'conservative revolution' that has since the beginning of the 1980s had a profound influence on policies in a large number of industrial countries, as well as in some developing countries. This subject remains highly controversial, however, and it will be useful to commence our discussion of adjustment policies by briefly surveying the state of this argument.

II.1 Market failures

Traditionally, the economic role of the state has been defined in terms of a responsibility to correct for, or eliminate, various 'market failures'. There is an extensive literature on this subject, from which the following list can be distilled.²

- [a] **Failures of competition.** Briefly, this can be said to exist whenever monopoly or monopsony power exists in a market. It has led governments to promote by various means greater competition or to safeguard against the abuse of monopoly power.
- [b] **Externalities.** These are costs associated with an output which accrue to society at large and are not reflected in producers' costs of production; or benefits which are not reflected in their revenues. The damage caused to the environment by industrial waste disposal is a common example of an external cost. The value to local farmers of tracks created by timber hauliers is an example of an external benefit.
- [c] **Incomplete markets.** This condition can be said to exist when markets fail to produce items which people desire and for which they would be willing to pay more than the costs of production. One widespread example is the frequently incomplete coverage of credit markets in rural areas. Another is the paucity of 'futures' markets, which would permit people to enter into contracts for the supply of a good or service at some future date at a price determined

¹ The literature on this, and its relevance to the role of the state in developing-country circumstances, is explored in Killick, 1989, on which the next few pages are based.

² For discussion of these see Stiglitz, 1986, upon which much of the following list is based. See also Arndt, 1988, particularly on the subject of 'dynamic' market failures.

now. One consequence of this is to increase uncertainty, discouraging investment or leading to investment 'mistakes'.

- [d] **Information failures.** Market forces tend to result in an under-production of information to which public access cannot easily be limited and which, therefore, cannot be profitably sold. The role of government to remedy this defect has already been given some prominence in the discussion in Working Paper No. 31 of the importance of information for economic adaptation.
- [e] **Public goods.** This is the name given to various desirable goods and services that would not be supplied (or not supplied efficiently) by private enterprise, including the maintenance of law and order, national defence, public health, etc. The type of co-operative actions needed for the provision of this type of service will not normally result from the competitive maximisation by individuals of their own welfare, necessitating imposed provisions by the state.
- [f] **Merit goods.** These relate to items in the use of which individuals are not regarded by the state as acting in their own best interests. Most of the examples are negative: laws against the use of narcotics; the discriminatory taxation of alcohol. Compulsory education is a positive example.
- [g] **Macroeconomic instability.** This refers to the tendency for unregulated market economies to experience cyclical or short-term instability - the periodic occurrence of recessions and of inflationary booms. It was his analysis of this, and his assertion of the duty of the state to rectify this failure, that was Keynes' chief contribution to the theory of economic policy.
- [h] **'Creative' failures.** Most of the above relate to failures that reduce the efficiency with which resources are allocated at a given time. The idea of creative, or dynamic, failures relates to situations where the production frontier is not being expanded over time at an optimal rate. This may result from suboptimal levels of saving and investment, perhaps due to scale economies, or from inadequate supplies of entrepreneurial skills to exploit economic opportunities and propel the economy forward. Indivisibilities, high risks or inefficient capital markets may similarly result in suboptimal rates of innovation. This type of failure is liable to have particularly serious consequences for the processes of economic adaptation.
- [i] **Poverty and inequality.** The existence of such conditions may be regarded as a type of failure when market forces result in conditions which are inconsistent with what society regards as equitable or reasonable.

BOX I. MARKET FAILURES

Segmented and Incomplete Markets: Dualism in Zambia's Agricultural sector³

Before 1980 Zambia's agricultural sector was split between 6,000 large commercial and approximately 650,000 smallholder farmers cultivating less than 2 hectares each.

Underlying this split was dualism in input and product markets. Financial dualism meant that commercial farmers had access to banks and other institutions, and could borrow at lower interest rates than smallholders, who were forced to turn to moneylenders or had no access to credit. Differential access to finance in turn contributed to technological dualism. Smallholdings remained labour-intensive and dependent on simple hand tools: they were unable to purchase oxen or tractors, and their small unspecialised farms permitted no economies of scale. Meanwhile commercial farmers were able to invest (notably in irrigation), and modern technology became concentrated in the commercial sector. Other inputs, such as fertilisers, pesticides and improved seed varieties, were largely confined to the commercial farmers. Their greater buying power, and access to information and credit, made them able to purchase at wholesale prices (while smallholders paid retail prices), to take advantage of changes in subsidies on fertiliser, and to direct agricultural research and extension services to their needs. They were also better able to compete for labour, while smallholder production was constrained by labour shortages.

Commercial farmers also had greater access to (and control over) product markets. They were located closer to major transport links, and able to organise their own road transport or storage of produce. This enabled them to overcome seasonal and regional price variations; to reduce losses due to crop spoilage; to avoid middlemen by selling direct to retailers; to cut the costs of transporting inputs; and to respond more quickly to changes in the prices of different crops.

Thus input and product markets were segmented or incomplete, with access to both of them easier for commercial farmers, resulting in dominance by overmechanised and import-intensive commercial farms.

Environmental Externalities: Estuarine and Marine Pollution in West Africa⁴

Thousands of substances enter river estuaries and coastal marine waters due to industrial and agricultural production processes. Some, like DDT and artificial radio-active materials, are alien to the water; others, such as mercury and lead, are naturally present, but unregulated industrial waste disposal or agricultural pesticide use increases their concentration and combines them in ways which pollute marine and fresh waters, with negative effects on marine wildlife, fishing and human health.

Pollution of West African coastal waters became increasingly severe in the 1960s and 1970s. Unregulated growth of industrial production in coastal urban areas led to a rapid rise in industrial waste. Outside urban areas, industries (for example, making timber products, processed foods and textiles) released unprocessed effluents into waterways. Oil exploration and exploitation brought pollution, through spills of crude oil and refined products during extraction, loading and transport. Commercial farmers used more chemical fertilisers, herbicides and pesticides, which led to discharges of wastes and residues into estuaries and coastal lagoons.

These were all examples of external diseconomies. Producers were able to keep down their internal costs by dumping their wastes instead of dealing with them within the production process - and it was society that paid. Thus, fishermen were hit in all coastal waters between Côte d'Ivoire and Gabon. Shrimp catches collapsed in the lagoon fisheries of Abidjan; several commercial seafood and fish species entirely disappeared from all waters between 1973 and 1980. Surface oil slicks killed tuna *larvae* in breeding grounds off Ghana, with knock-on effects on regional tuna stocks. It is probable that there were adverse effects on the health of the wider population as well, with both human and economic consequences.

³ Based on unpublished World Bank Sources.

⁴ Based on Ruddle and Manshard, 1981.

Although some of the above items are disputed, there is little dissension by economists from the idea that market failures - illustrated in Box I - are widespread and often serious. What is now a good deal more controversial is the traditional inference in the theory of policy that the existence of market failures constitutes an adequate case for state interventions to rectify these, or compensate for them. It is no longer taken for granted that government intervention will make things better. Experience has taught caution, for a number of reasons.⁵

II.2 The costs of policy

One reason for caution relates to the complexity of an economy - even a low-income economy - and of the effects on it of a given policy change. For one thing, varying time lags are involved between government perception of a need for action, a decision to introduce a policy corrective, the implementation of that decision, and its effects on the economy. In consequence, the economic situation may materially have changed by the time a policy shift works its way through the economy, making it less relevant, maybe even harmful. Moreover, the government's knowledge of how the economy works is inevitably imperfect, making some policies rather hit or miss, and sometimes unwittingly magnifying mistakes by individuals in the marketplace. Governments, furthermore, have only imperfect control over the ways in which their policies are actually implemented on the ground and, therefore, over the consequences of their actions. In addition, Working Paper No. 31 has already placed importance on the ways in which public reactions can render government policies impotent, and we shall be returning to this later.

Government actions have a habit of necessitating higher tax revenues, and a further reason for some turning away from the market failures approach, in industrial countries at least, was a seemingly inexorable rise in the share of national income taken in taxes. There were the beginnings of a 'tax revolt', indicated by growing tax evasion and changes in voting patterns in favour of political parties promising to give priority to lowering taxes.⁶ This was not just a matter of public preferences: economists began also to place greater weight on the potential disincentive effects of high taxes and on the 'distortions' such taxes can create. One aspect of this was a

⁵ See Lal, 1983, for a highly sceptical treatment of the efficacy of the state in developing-country circumstances.

⁶ In the OECD countries taken together current government receipts as a percentage of GDP rose from an average of 28% in 1960 to a peak of 36% in the early-1980s [cf. Killick, 1989, p.16]. Unfortunately, equivalent time series are not available for low-income developing countries.

greater tendency to see a trade-off between economic efficiency and measures to reduce poverty or income inequalities.

In short, there is nowadays a greater awareness that state interventions involve costs as well as benefits; that there are 'state failures' as well as market failures. Two illustrations are provided in Box II. Macroeconomic instability is one of the market failures listed earlier but this provides a further illustration of state failure, for there would now be wide acceptance that the state is itself a potent source of such instability, not least because of large budget deficits. There is also recognition that medium-term development planning has often failed to bring many of the benefits expected of it. At more microeconomic levels, government policies are also seen as a source of inefficiencies, for example *ad hoc* and unsystematic decisions about industrial protection, or policies biased in favour of the urban population, or through controls over prices and wages.⁷ The poor economic and financial performance of many state enterprises has similarly contributed to the new scepticism about the efficacy of the state. And as we will see later, there is also less inclination to assume that the state's intentions are benign, with some writers seeing it instead as predatory.

This type of re-thinking about the state is, moreover, occurring across the political spectrum; it is not just a product of the 'conservative revolution'. Thus, writing from a socialist perspective Dearlove and White [1987, p.2] conclude that "The case for the market and against the state is now widely accepted, not the least among socialist economists...".⁸ Economic reforms under way in the Soviet Union and other socialist countries provide further evidence, with the senior Soviet Politburo member responsible for ideology stating what would earlier have been a heresy, that the marketplace is an "irreplaceable means" of meeting consumer demand.

So, both markets and states can fail. The activities of each are attended by both costs and benefits. Ideological approaches - left or right - to what ought to be the respective sizes of the public and private sectors are unlikely to be very sensitive to these complications and hence are unlikely to strike the best balance. Indeed, it is probably unhelpful to pose the question of the desirable role of the state in general terms. Rather, it is something that has to be worked out against the specific background of the history, socio-economic system, ethical values and goals of the country in question.

⁷ See Balassa, 1988, on policy-induced distortion in developing countries. He is particularly concerned to trace the ways in which such distortions in product and factor markets interact with one another.

⁸ See this and various other issues of the IDS Bulletin for documentation of the re-examination of socialist writers of the role of the state in developing countries.

BOX II. GOVERNMENT FAILURES

Kenyan Price Control⁹

Since long before Independence in 1963, the Kenyan government regulated the prices of basic foodstuffs. To combat inflation and protect its own popularity the government decided in the early 1970s to extend controls to non-food consumer goods, construction materials and agricultural inputs. Prices of a list of manufactured items and some services were frozen and could not be increased without ministerial approval.

The effect was to politicise price decisions, and ministers were reluctant to be seen to be raising prices. They thus deferred decisions by insisting on complex supporting documentation and postponing face-to-face talks. Even then they delayed approval and implementation until the applicant gained the support of the Office of the President.

By the early 1980s, this policy had become a drag on the industrial sector. Several enterprises forced to hold down prices became a burden on the credit system. Profitability was reduced, diminishing incentives for expansion and new investment. Industries, such as dry-cell batteries, which had invested ahead of domestic demand and exported the surplus, were discouraged by an artificially stimulated domestic demand from exporting and expanding employment. Price controls came to retard industrial development.

Indian Regulation of Industry¹⁰

Until 1984, India's industrial policy was based on government controls designed to direct investment to priority industries and backward regions, and to conserve scarce resources by striking a balance between domestic supply and demand. The key regulatory mechanism was restriction on entry into various industries. The private sector was barred from setting up new capacity in certain sub-sectors, large industrial groups and foreign companies were barred from others, and their success with applications in other sub-sectors was under 25%. More than 800 items were reserved for production by small firms.

Control was exercised through industrial licenses, which were required for firms intending to establish new undertakings, to expand capacity substantially, or to manufacture certain new products. Furthermore, site selection for plants had to be approved by central, state and local governments. Imported capital goods also required official clearance, as did technological or financial collaboration with foreign companies.

This system (including high rejection rates) helped create an industrial structure of high concentration and cost, and often of low technological adaptation and product quality. It was easily manipulated by large companies, which cornered high percentages of licensed capacity by submitting multiple preemptive applications through chains of associate companies. Having beaten off all competition, they then delayed actual creation of new capacity, in order to create near-monopolies which yielded excessive profits. Indeed, these activities well illustrate the concept of 'rent-seeking' referred to in the main text. The licensing system also prevented technological and productivity improvements, notably in motor car manufacturing. Reservation of items for small firms often fostered uneconomic capacity and outdated technology, and limited economies of scale. The necessity for multiple approvals made project delays and cost overruns inevitable. The negative effects of these controls were demonstrated by a surge of new investment and rapid rises in productivity when licensing was partially liberalised after 1984.

⁹ Based on Gray, 1988.

¹⁰ Based on Behara and Chandrasekhar, 1988, pp.142-47, and World Bank, 1987, p.116.

Within such a context, the pragmatic solution is then a matter of determining the comparative advantages of the private and public sectors, of balancing the costs against the benefits of any possible intervention. The stance here, then, is one of neutrality, of a case-by-case consideration of the relative merits of any action or inaction. It is an approach which is powerfully reinforced by modern economic theory, which stresses the difficulties of deriving general policy prescriptions in a second-best world, and the desirability of carefully balancing the merits of voluntary (chiefly market) and coercive (chiefly governmental) decision mechanisms.

Having thus declared our neutrality and advocated a comparative advantage, or cost-benefit, approach to defining the role of the state, a great deal is left to be settled. For one thing, the boundary between the public and private sectors is often unclear. There are jointly-owned enterprises. The state may subsidise private products, and the private sector may provide services normally associated with the public sector, e.g. in education and health. Politicians, even public servants, may engage in business; and businessmen may depend crucially on favours provided by the state.

At a different level, the cost-benefit approach will rarely be capable of being effected literally, as if it were a project evaluation. There will usually be too many uncertainties, too many factors that cannot be quantified or be expressed in monetary values. The approach is suggested mainly as a logical framework for thinking about the issue. As such, much is left for questions of judgement, and for disagreements about goals and how best to achieve them. What is likely to emerge, as is suggested shortly, is that the nature of state interventions is likely to be more important than the extent of them, particularly whether policies work through and with market forces, or against them.

III. STRATEGY CHOICES

In approaching its attitude towards economic adaptation a government is confronted with a number of strategic choices. Three key choices are discussed in what follows but these are not of equal status, in the sense that one choice will influence the others. The first decision is about whether the government's approach to the tasks of adjustment is to be a positive, passive or defensive one. A decision on that has a logical priority because it will influence second-order strategy decisions.

The next decision discussed in this section concerns the view the government takes about integration into the world system of trade and payments. This can be dramatised as a choice between an open- or a closed-economy approach, although in practice the decisions are less dramatic ones about the degree and speed of integration. A decision on the 'open versus closed' question will in turn strongly influence the third-order strategy choices discussed below about [i] the nature of supportive policy interventions and [ii] the role of macroeconomic management. But the open versus closed choice will also feed back into the first-order choice between positive etc. policy stances, as we will see.

III.1 Positive, passive, defensive?

The question whether the stance of policies towards adaptation should be positive, passive or defensive appears to answer itself, in favour of a positive approach, but we should first clarify what is meant by these options. A **positive** strategy can be described as one where the state plays an active role in facilitating adjustment, seeking to anticipate problems and opportunities and to put in place policy measures that will induce, or support, the appropriate changes in economic and institutional structures. It is a stance that embraces change as positively desirable and that seeks to derive benefits from it. It sounds like A Good Thing - but it can be uncomfortable and can imply a strong state which is willing to ride roughshod over tradition, non-economic values and opposition.

The **passive** alternative can be defined as an approach to policy which still recognises the desirability of adaptation but is more content to allow this to happen automatically in response to economic pressures and incentives, and with a less active role for the state. It implies a more reactive, gradual pace of change, in which the country is unlikely to be among the leaders taking maximum advantage of the opportunities created by it.

Finally, there is the **defensive** option. This sounds an unattractive stance but it characterises the position of a large number of governments, in industrial and developing countries alike, which suggests that it too has virtues. Perhaps the key characteristic of a defensive approach is that it seeks to reduce

the social costs of change, by slowing it down and/or by compensating the losers. The protection of industries that have lost their ability to compete is a typical example of a defensive policy. Faced with the threat of unemployment in these industries, the defensive response is to protect the jobs for as long as possible, as against a positive stance of labour re-training and relocation. Since structural adjustment can indeed result in major social costs and can particularly threaten some of the poor (see below), it is entirely appropriate that governments should be concerned to minimise such risks - so the defensive stance is perhaps not such a bad thing after all. Its great weakness, however, is that it may prevent the economy from adapting to the extent, and at the speed, necessary if it is to prosper in the modern world. Over time it may thus seriously undermine the economic base necessary if the state is to be in a position to safeguard the living standards of the disadvantaged. The United Kingdom in the 1960s and 1970s provides a good example of an industrial country adopting an essentially defensive stance, and losing economically as a result. Among low-income developing countries, it might be said that most African governments have proved willing to provide threatened industries with sometimes extreme degrees of protection against foreign, and often domestic, competition to allow them to continue in existence with out-moded products, at considerable cost to consumers. Because of the ultimately self-defeating nature of a defensive stance, some writers, particularly associated with UNICEF [1987, 1988], have developed the idea of 'adjustment with a human face', in which protection of the interests of the poor is built into the design of adjustment policies, seeking to combine the advantages of a positive stance with the minimisation of social costs. We will return to this topic in Working Paper No. 34.

It is evident from this brief discussion that choice between positive, passive and defensive policy stances is not as obvious as it may at first have seemed. Each has its strengths and weaknesses. As with so many policy choices, it is a matter of striking the right balance - in this case between the advantages and discomforts of change. **A positive approach appears the most likely to facilitate successful adaptation, but this needs to be tempered by concern to minimise the economic and social costs that adaptation will cause.** However, a government's choice between these alternative stances will be intimately connected with the choice between an open- and a closed-economy approach, so let us next turn to that.

III.2 Open versus closed economy strategies

• Meaning and significance:

Having already issued the caution that we are actually discussing the degree of openness that is desirable, not a choice between complete free trade and total autarchy, what then is meant by an open- or closed-economy strategy? So far as trade is concerned, it particularly relates to the profit incentives as between

producing for domestic or external markets created by policy decisions about exchange rates, protection, exchange controls and the like. Closed-economy policies will tip incentives in the direction of producing for the home market, emphasising import-substitution, food self-sufficiency and perhaps non-tradeables; open-economy policies will create greater profitability in producing for export. It may be useful to identify two versions of an open economy strategy: [i] one that skews price incentives positively in favour of exports, e.g. through export subsidies; and [ii] one that aims for approximate price neutrality as between production for domestic and external markets. Strictly speaking, the second, being neutral, ought not to be labelled 'open-economy' at all. The fact is, however, that most governments run policies that are skewed in favour of producing for the domestic market, chiefly through protection, so that the effect of adopting price-neutral policies is to move incentives in favour of greater openness. We might call this 'price-neutral openness'.

The essence of price-neutral openness is that it adopts ability to produce tradeable goods at internationally-competitive cost levels as the key test of efficiency, which is close to saying that it allows the composition of imports and exports to be determined by comparative advantage. Import-substitution may still be a policy objective, but only substitution by producers who need little or no more protection than that provided by the transport and other costs involved in importing from abroad. This is a clearly different type of policy stance from the protectionism normally associated with import-substitution strategies.

An open-economy strategy thus has strong implications for tariff and other forms of protectionist policies. More positively, since it seeks to remove any profitability bias against production for export, such a strategy also has strong implications for exchange-rate policies, requiring these to be maintained at levels which ensure export profitability. In principle import-substitution is also promoted by competitive exchange rates, but in practice such strategies have commonly been associated with reluctance to use the exchange rate as an active policy instrument, often leading to an over-valued currency. There are implications too for domestic macroeconomic management, in that it is difficult to work an open-economy strategy successfully in the face of strong inflationary pressures and other major imbalances at home, particularly because rapid inflation tends to erode the effects of exchange rate policies.

The openness discussed thus far has been related to imports and exports, or to the current account of the balance of payments. It can, however, be argued that the full advantages of openness will be secured only by the adoption of a thorough-going approach extended to the capital account, involving the liberalisation of payments, an absence of controls over capital movements in and out of the country, and policies to encourage foreign investment. That, however, is a separate set of choices, for it is possible

to combine an open trading policy with the maintenance of exchange controls and discrimination in favour of local investors.

Whichever way the decision goes, it is already clear that it is a decision with very important ramifications for many aspects of economic life. For one thing, it will make a major difference to the pattern of production and to changes in this over time - to the very process of structural change which is the subject of this series of Working Papers: to the distribution of production as between tradeables and non-tradeables, and among tradeables between exports and importables; to the relative intensities of resource use, because exports, import-substitutes and non-tradeables each have their own production characteristics; and through the effects on factor and product markets to the distribution of income and purchasing power. In manufacturing it will much affect the pattern and the pace of industrialisation. In agriculture it will affect the allocation of land and other resources as between foodstuffs and export crops. As we shall suggest presently, it will also have a large influence over the type of economic policies that can be successfully pursued by government and on the degree of freedom the government possesses in choosing its policies. Indeed, one of the continuing attractions to governments of a closed-economy strategy is that it gives them a greater degree of discretionary action.

• The pros and cons:

The choice between open and closed approaches is thus a 'big' one, arguably the big one. Perhaps because of this, the *pros* and *cons* of these alternatives remain the subject of fierce controversy. In the 1960s and beyond governments tended to be more influenced by those advocating relatively closed-economy approaches, particularly import-substituting industrialisation behind protective barriers. During the last decade or more the balance of opinion, at least among development economists, has swung more towards the open-economy alternative. The arguments can be organised around the different types of effect the two approaches are expected to have.¹¹

There is first the effect of the strategy choice on the efficiency of resource use. We have already seen that an open-economy standpoint uses international competitiveness as the key test of efficiency. The argument here, then, is that bringing incentives for domestic resource use closer to international opportunity costs favours a more efficient, i.e. more productive,

¹¹ For statements of the open economy approach see Bhagwati, 1987; and Krueger, 1978. For a view more favourable to a closed-economy approach see Taylor, 1988(A). From further outside mainstream economics the 'dependency' school of writings is invariably sceptical of the value of openness and argues for some 'de-linking' from the world economy - see for example Amin 1976.

use of resources. The greater degree of competition faced by domestic producers will increase the pressures on them to keep their costs down to an unavoidable minimum (what is known as 'X-efficiency'), to maintain the quality of their products and to respond to changing technologies and user preferences. Negatively, a protective import-substitution stance is liable to result in fewer competitive pressures, greater industrial concentration, and a probably less responsive, more 'frozen' productive structure - recall the argument of Working Paper No. 31 that competition promotes economic flexibility. Moreover, an import-substitution strategy is likely to be accompanied by 'rent-seeking' activity, as domestic producers use skills and other resources to lobby politicians and officials for protection and monopoly power - resources that could otherwise be put to productive use - and this is likely to be particularly important if the strategy is accompanied by the use of exchange controls. The static efficiency argument, then, is one that goes in favour of openness, although it is in the nature of the case that it is difficult to measure these benefits and there is disagreement about how large these are likely to be.

The arguments are better balanced when we turn to more dynamic considerations relating to innovation and investment. On the one hand, it can be argued that full involvement in highly competitive international markets brings the benefits of learning-by-doing and acquaintance with up-to-date production techniques; and it is suggested that openness is associated with more rapid rates of productivity growth and innovation. The counter-arguments point to the beneficial effects of having a substantial locally-based capital-goods sector meeting local needs (even if it needs protection), as against the negative effect on local know-how of dependence on imported capital goods and technologies; and to the experiences of countries like Japan, which achieved its present-day technological leadership on the basis of highly protective policies.

Efficiency, technologies and innovation are all affected by one of the most important features of modern production: economies of large-scale production. This brings us to a crucial point, for we must recall that this study is primarily concerned with small, low-income economies, i.e. economies in a poor position to take advantage of scale economies. The argument here is that the only way producers in a small economy can take advantage of scale economies is by selling on world markets, for their domestic markets are far too small for this purpose. This is even true within the medium-sized industrial countries of the European Community.¹² How much more true it must be, then, of

¹² The desire for European producers to be able to take greater advantage of scale economies was, for example, one of the reasons for the move for fuller integration of the European Community economies in 1992. Thus, the OECD [1983, p.63] writes of firms in medium-sized industrial economies being squeezed out because of their inability to achieve scale economies; and Pratten [1988] sees the 1992 integration as an

producers in small, poor developing countries. Consider the illustrative figures in Table 1, which provides alternative measures of economic size for four country groupings.

This shows first how misleading it is likely to be to measure size in terms of population. By this measure the averages of the 'large low-income countries' (China and the countries of the Indian sub-continent) are enormously bigger than of the other groupings, yet their average GDP is little more than a tenth of that of the average industrial market economy. If we are concerned with total market size the GDP is a better indicator. If we are concerned with the market for consumer goods then the averages for total private consumption in column (3) are more useful. If we want to focus particularly on industrial consumer goods - for it is in manufacturing that scale economies are most important - then column (4) is the most useful. If, finally, we are concerned with the size of the domestic market for capital goods, as influencing the ability of domestic capital goods industries to achieve scale economies, then the column (5) averages are the most pertinent.

By all the measures except population the results are dramatic for the small low-income countries: their average GDPs, consumer-good markets and capital-good markets are tiny by comparison with all of the other three groupings, but especially by comparison with an average industrial economy. No refinement of the figures would significantly alter this result. For industrial consumer goods and investment goods, their markets are less than one-five-hundredth of the size of the average industrial economy, yet even in these latter economies there is concern that their producers are unable to take full advantage of scale economies!

Of course, scale economies vary in importance for different types of output. They do not matter much for quite a lot of agricultural products and services. Even within industry, their importance varies. They are relatively insignificant in a variety of consumer goods: clothing, food processing, jewelry and others. They are far more important in the production of most consumer-durables and capital goods: steel and other metals, motor vehicles, chemicals, etc. But taking manufacturing as a whole, scale economies are large and it is worth quoting the conclusion of a thorough survey of the importance of this for developing countries [Sutcliffe, 1971 pp.226]:

There is a large number of industries... in which economies of scale can be obtained up to levels of output greatly in excess of those in most underdeveloped countries, and also greatly in excess

important means of achieving greater scale economies through longer lines of production and through increasing returns to R&D expenditures.

Table 1: Indicators of domestic market size, circa 1985
(country averages; \$ billions except column 1)

	Population (million)	GDP	Private consumption	Private consumption of manufactures ^a	Gross investment
	(1)	(2)	(3)	(4)	(5)
1.Small low-income countries ^b	12.1	2.8	2.2	0.6	0.4
2.Large low-income countries ^b	509.5	148.5	92.1	21.2	47.5
3.Middle-income countries	21.9	32.2	20.3	6.7	7.4
4.Industrial market economies	39.0	1373.4	851.4	323.6	288.4

Source: Computed from 'World Development Indicator' tables of World Bank, World Development Report, 1988, Tables 1, 3, 5 and 6.

Notes:

- (a) An approximate indicator only, calculated from share of private consumption devoted to clothing and footwear, and 'other consumption' as a rough proxy for expenditures on manufactures.
- (b) 'Small' and 'large' are defined as countries with populations of below and above 50 millions. The 'large low-income country' group consists of Bangladesh, China, India and Pakistan.

of current consumption of those commodities in the same countries...

It is as a result of such factors that we found in Working Paper No. 31 that country size has a strong influence on the importance of international trade relative to domestic economic activity. What this suggests is that the costs to a small low-income economy of adopting a closed-economy strategy are liable to be very large. These include effectively foreclosing the possibility of successful industrialisation - which we also suggested in Working Paper No. 31 would have an important 'enabling' influence on an economy's flexibility - beyond the simplest consumer-good import substitution. The scale economy argument, then, is one that goes strongly in favour of openness.

However, there is an ambiguity for policy about this conclusion. For if the local market is as minuscule as indicated in Table 1 the question arises, how can local manufacturers ever get started, grow to a size that would enable them to compete with the giants of the industrial world? The importance of scale economies can be used as an argument in favour of protection of local industry until it has been able to move far enough down its cost curve to no longer need protection, which runs against the general thrust of open-economy policies. This, unfortunately, is an argument we cannot get into here. Briefly, it hinges upon judgments about whether governments can be trusted to confine protection to economically justified cases, phasing it out as the justification fades, and about the likelihood of retaliation by the rest of the world.¹³

Its impact on the balance of payments (BoP) is another dimension of the debate about openness, one to which much weight should be attached given the importance of the foreign exchange constraint described in Working Paper No. 31. *A priori* it is difficult to generalise whether an open or closed approach will be best for the BoP. Policies which emphasise self-sufficiency and import substitution, by reducing import needs, can in principle leave the BoP in satisfactory condition. In practice they tend not to, however. This is chiefly because closed-economy approaches are commonly (but needlessly) associated with over-valued exchange rates and price biases in favour of the production of non-tradeables. It is also a common experience that 'import-substituting' industries save little or no foreign exchange, being often heavily dependent on imported inputs for production, investment and sometimes management.

If openness is indeed associated with maintenance of more competitive and flexible exchange rates, there must be a general presumption that it will produce better BoP results, by giving greater encouragement to exporters and placing greater importance on international competitiveness. It may also do better by providing a more favourable environment for inflows of

¹³ See Venables and Smith, 1987, for an exploration of this issue.

foreign capital (although here too the contrary argument could also be made - that protection of local industry will encourage foreign investors anxious to maintain a foothold in the local market). But while, on balance, the BoP consideration points in favour of openness, the validity of this conclusion does depend upon the conditions that are assumed to exist in the rest of the world and we will revert to that shortly.

It ought to be possible to settle disagreements about the *pros* and *cons* of open and closed approaches by reference to the evidence. The balance of the arguments presented above is to the advantage of openness, and from this we could derive the hypothesis that developing countries which have pursued open-economy policies have achieved superior economic performance. Considerable effort has been devoted to testing the relationship between export performance and economic growth, with results which mostly conclude that export performance does indeed have an important bearing on growth.¹⁴ Thus, Ram [1987] found positive associations between export performance and growth, using both cross-country and individual-country tests. Moreover, he found that the influence of exports on growth has been increasing over time, and in more recent years has been of particular importance to low-income countries. However, the results of the empirical work have not been completely conclusive, much depending on the way the problem is defined and tested. In-depth studies of the experiences of specific countries have also been undertaken but these too are not conclusive.¹⁵ So while, on balance, the empirical studies do find in favour of openness, controversies remain.

Interpretation of the evidence is complicated by the large amount of attention that has been paid to a small number of success stories of openness, particularly the 'Four Little Tigers' of Southeast Asia: Hong Kong, Singapore, South Korea and Taiwan. These, and a limited number of other newly-industrialising countries in Asia and Latin America, have achieved major success in expanding their exports of manufactures, chiefly to industrial-country markets, and have undergone remarkable economic transformations as a result of this success. Even here, however, there is much controversy about the interpretation that should be placed on their records and the inferences that might be drawn for other developing countries: are they exemplars or special cases?

¹⁴ See Ram, 1987, for a recent contribution and useful bibliography of the empirical literature. Ram finds that growth is positively associated with export performance but Taylor, 1988(A), finds no correlation between trade liberalisation and economic performance and a weak association only between export performance and economic growth.

¹⁵ See, in particular, the country volumes of which Bhagwati [1978] and Krueger [1978] provide the synthesis; and the country studies of which Taylor [1988 B] is the synthesis.

For one thing, most of them do not provide pure examples of an open-economy approach, having (with the exception of Hong Kong) also pursued protectionist, import-substitution policies. Moreover, their examples do not necessarily indicate the superiority of market over government decisions, since they (again with the exception of Hong Kong) have had highly activist governments, of which Korea is the chief illustration. The Little Tigers have also benefited from relative ease of access to the markets of the USA and from being the first developing countries to achieve major success with industrial exports: those who would emulate them face a harder task. Notwithstanding these qualifications, however, each of these countries has pursued generally market-oriented strategies, with governments supportive of private enterprise and willing to allow the composition of exports and imports to be broadly determined by comparative advantage. Each has benefited enormously as a result, so the onus of proof is now upon those who argue that the Little Tigers should not serve as exemplars for the rest of the developing world.¹⁶

• Conclusions:

How should we conclude on this crucial choice between open- and closed-economy cases? Here the decision to focus this series of Working Papers on small, low-income developing countries is a crucial influence, for it is the economies of scale argument, as dramatised in Table 1, which is decisive. Leaving aside all the other pros and cons, it seems that such countries have little choice but to adopt an open-economy stance - especially if they are to develop the industrial base which we have identified as one of the key enabling determinants of flexibility. Amongst present-day writers on this subject, Lance Taylor ranks as one of the most sceptical about the virtues of openness, but even he has concluded that: "In a smaller nation, more openness becomes inevitable. The constraint may bind at a population of (say) 20 million - surely no less."¹⁷ As suggested earlier, expressing economic size in terms of population is not ideal, but if we bear in mind that the average population of the countries we are concentrating on here is about 12 million (Table 1) and that they have below-average per capita incomes compared with the Third World as a whole, the implication of Taylor's conclusion is strongly consistent with ours: that for the small low-income country the costs of a closed-economy approach will be prohibitive. The case is further strengthened if one places weight on the suggestion that such an approach is also likely to worsen balance of payments performance and, hence, the foreign exchange constraint; and on the importance of competitive pressures for efficiency. It was for reasons such as these that we concluded

¹⁶ For a useful brief discussion of these cases see Campbell's 1988 review of three recent books on these countries.

¹⁷ Taylor, 1988(A), p.67 (emphasis added).

in Working Paper No. 31 that openness was favourable to economic flexibility. Moreover, the balance of the evidence is consistent with the view that openness has a favourable effect on GDP growth, even though it is not fully conclusive.

But if we conclude in favour of an open-economy strategy, do we mean price-neutral openness or one in which prices are positively skewed in favour of producing exports? There is one theoretical and various pragmatic reasons for preferring price-neutrality. The theoretical argument takes us back to efficiency considerations. Price incentives skewed in favour of exports are no less 'distortions' - departures from the perfectly competitive case - than incentives skewed in favour of non-tradeables. The logic of static efficiency arguments points generally in favour of price neutrality, although the recent literature on trade policy contains some sophisticated arguments in favour of export subsidies, and we suggest in a moment the desirability of policies that positively favour non-traditional exports.

The pragmatic considerations have mainly to do with the risks and potential costs of over-exposure to an often hostile and unstable world economy. Indeed, as suggested earlier, decisions about openness must also be influenced by expectations about the global economic environment. How fast - and how smoothly - will the world economy and trade be growing? What is the likely trend in the world prices of the country's exports, and in its terms of trade? What is the probability that its exports - particularly of manufactures - will hit against protective barriers, i.e. how good will its market access be? What realistic prospect is there that greater openness will increase access to world capital markets and private investment, and on what terms is any capital likely to be made available? The gains to be had from openness will much depend on the answers to these questions. The risk that world conditions will be unfavourable argues against going too far in the promotion of openness.

There is a further precautionary consideration, that of food security. Although it is very easy to exaggerate, there is a case for policies which give some preference to producers of strategic foodstuffs. The climatic shocks discussed in Working Paper No. 31 can easily lead to a sudden failure of the harvest, perhaps for a succession of years, and it is risky to depend wholly on international markets to make good the shortfall. World prices may be too high at that time, or imported supplies slow or unreliable. To recap from the previous Working Paper, what is needed is a judicious blend of policies which protect the economy from the worst of the risks of over-exposure to world economic conditions and of policies which open the economy up to the opportunities of trade and investment.

Our conclusion, then, is in favour of a pragmatic price-neutral open-economy strategy as the one that is most conducive to economic adaptability and, therefore, to long-run development. But what now do we say about the choice between the positive,

passive and defensive postures with which we commenced this discussion of strategies? In part this choice relates to the view we take of comparative advantage. In trade theory this is a static concept, referring to countries' relative efficiencies in producing tradeable goods. This type of static efficiency view implicitly favours a passive stance: in the absence of major distortions price signals will automatically lead countries to export those goods to which they are best suited.

But comparative advantages change over time, and have done so with special rapidity in recent decades. In this situation there are large gains for those countries which are successful in anticipating changes in demand and production conditions so as to 'get there first' in world markets. Such a dynamic view of comparative advantage points more towards a positive policy stance, with governments (among others) taking a conscious view about how their countries' competitive advantages are likely to change in future. If there is a single lesson that might be applied from the Asian Tigers to other developing countries it is the importance of taking a positive view of dynamic comparative advantage: encouraging shifts in resources in favour of industries facing dynamic world markets, and which generate technological and other externalities at home - and not being too protective of those industries that face decline.

For the countries with which we are concerned here, these considerations draw special attention to the desirability of governments' taking a view of their future dependence on traditional primary product exports, for reasons also mentioned in Working Paper No. 31. We can here do no better than to quote the conclusions of an IMF study of export diversification, although the authors do follow this passage with some qualifications [Bond and Milne, 1987, p.120]:

Recent empirical evidence shows that export diversification into manufactured goods can raise the trend path of export earnings since: (1) the net barter terms of trade for primary products, as a group, compared with manufactures has deteriorated over the long term; (2) the income elasticity of demand is higher for manufactured goods than for primary goods, in aggregate - implying that, for a given increase in trading partners' income, the increase in demand for manufactured imports will be greater than for primary products; (3) the demand for imports of primary products is less price elastic than that for manufactures - so that an increase in the total volume of primary exports will lead to a greater reduction in export price than would an equivalent increase in that of manufactured exports; (4) in the short run, supply elasticity for primary products is less than that of manufactured goods; and (5) export diversification may help circumvent barriers to trade.

The strategy suggested here, then, is a positive one of diversification away from traditional primary products. Openness is, in effect, imposed by smallness. The task is then to treat this as an opportunity not an encumbrance; to get the most out of openness.

III.3 The policy environment

We concluded our earlier discussion of the role of the state in fostering the adaptive economy by urging a cost-benefit approach, allowing the respective roles of the public and private sectors to be determined by their comparative efficiencies in undertaking various tasks. In the light of this and of the above discussion of alternative strategies, we might now pose the further strategic question, how active should the state be in fostering the positive, open-economy strategy in favour of which we have just concluded, as against leaving it to market forces?

The state could confine itself, on the one hand, to a rather limited set of interventions, encouraging structural adaptation by the provision of information, advice and infrastructure; providing a legal and financial framework which will foster the desired pattern of change; seeking to reduce or manage the conflicts of interest that arise, and to ameliorate the costs of adjustment. It could, however, go well beyond such a minimalist role: adopting specific changes in economic structure as objectives of policy; actively manipulating price and other incentives in favour of such changes; directly participating in the change as regulator, employer and investor. Returning to the Four Little Tigers of Southeast Asia, Hong Kong could be cited as a successful example of the minimalist position; and Korea as an example of a state which has pursued very active strategies. Japan might be added as an earlier Asian example of successful state activism.

In support of an activist state it can be argued that market forces work gradually and incrementally - shifting resources at the margin - whereas structural transformation involves more radical, more discontinuous change which, therefore, will require the guiding hand of the state. The argument has particular force in contemporary conditions, when governments are under much pressure to achieve rapid adjustment in face of pressing foreign exchange and savings constraints. As we saw in the previous chapter, short-run price elasticities are often small, producing initially only limited responses to changed price signals. We also saw there that market imperfections are liable to be substantial in low-income developing countries and that this and other reasons point to a substantial role for the state in promoting economic adaptation.

This set of arguments should not be overdone, however. While it is true that markets work incrementally, the same is often also true of governments faced with many uncertainties, inertia

and the larger riskiness of radical change.¹⁸ Moreover, a succession of market-induced incremental changes can surprisingly quickly add up to a major structural shift. After all, the patterns of transformation experienced earlier in their histories by the now industrialised countries described in Working Paper No. 31 were, in a rough and ready way, brought about by market forces, although admittedly at often high social costs.

It was suggested earlier that the choice between open- and closed-economy strategies would itself have a strong bearing on the policy stance of the state. Anne Krueger has put the point forcefully:

...an export-promotion strategy appears to place certain kinds of constraints upon economic policy and its implementation; those constraints, in turn, limit the magnitude and duration of policy mistakes and also tend to force policies to work through pricing, rather than quantitative, interventions...a growth strategy oriented towards exports entails the development of policies that make markets and incentives function better... [Krueger, 1978, p.284].

The crucial decision is to allow resources and the pattern of production to be shaped largely by international norms of competitive efficiency, for that is very close to a decision to permit resources to be allocated through market signals, as against controls and 'planning'. While it is true that in such countries as Korea the state has been active and interventionist, it is also true that the interventions have generally worked through markets, influencing prices and incentives. It would be hard to find a country that has successfully pursued an open-economy strategy on the basis of central planning and extensive non-market controls. It is also the case that few governments could be relied upon to match the toughness of the Korean in dealing with the pleadings of industrialists and other special-interest groups.¹⁹

In particular, an open strategy demands that the exchange rate should always be such as to keep the country's exports and import-substitutes highly competitive. More generally, the constraints imposed by international competition may be thought

¹⁸ For a description and espousal of incremental government decision-making see Braybrooke and Lindblom, 1963.

¹⁹ Roemer, 1988 pp.9-10, sees the South Korean state as 'hard' in the sense of being the opposite of the 'soft' states that characterise many low-income countries. It exerted strong controls over subsidised credit, promoted large firms at the expense of small and then pressured the large to meet export targets. In doing so it was willing to see non-performers go into bankruptcy, with resulting job losses - and was strong enough politically to get away with it.

of as imposing relative consistency of policy upon governments: they have fewer degrees of freedom and the costs of policy mistakes bite harder and more quickly. Such consistency is likely to give to policies the credibility they need if they are to offer reliable bases for decisions about the future (see Working Paper No. 31, pp.37-8).

The case for policies which work with and through market forces can be augmented by returning to another consideration signposted in Working Paper No. 31: the importance for economic adaptation of the supply of entrepreneurship. If we extend a little further the lessons that might be learned from the more activist of the Asian Tigers, it is the importance of relationships between the state and private enterprise which are supportive rather than confrontational. While economists understand little of what it is that determines entrepreneurship, it is reasonable to believe that the policy environment can do much to stimulate or repress potential entrepreneurs: taxation and other policies affecting profits; the extent of regulation of business; access to finance (affected specifically by the extent of the government's own requirements for credit, i.e. by the size of the budget deficit); the provision of public infrastructure and training in support of private investments; and so on.²⁰

The policy environment matters in other ways too. The government's ability to maintain reasonable macroeconomic stability - the avoidance of rapid inflation, large-scale deflationary unemployment and large balance of payments deficits - is of crucial importance. It provides the steadiness and predictability of incentives that encourage long-term investment and price responsiveness so important to the adaptive economy. Rapid inflation is particularly destructive in this context, over-shadowing price signals and increasing the riskiness of investment and innovation.

Our conclusion, then, is for an activist state which, however, prefers to work with and through market forces rather than against them; which establishes supportive relationships with the private sector; and which places a large weight on the avoidance of major macroeconomic disturbances. In common with our earlier conclusion in favour of a broadly price-neutral open-economy strategy, this conclusion is, however, very general. How might it be translated into specific policy changes? To begin an answer to this we turn next to consider the policy instruments that are available to government in its pursuit of the adaptive economy.

²⁰ See Elkan, 1988, for a brief survey of these issues in an African context.

IV. POLICY INSTRUMENTS

IV.1 A policy matrix

For the time being we will focus our discussion on the policy matrix presented in Table 2. The horizontal axis sets out various 'target variables', or policy objectives, drawn from those factors which were identified in Working Paper No. 31 as being of particular importance for economic flexibility, with the addition in the final column of the further objective of minimising the social costs of structural change. The vertical axis lists categories of government policies that might contribute to the achievement of these objectives, or in other ways impinge upon them. The matrix itself indicates when the policy example is likely to have a positive (P) or negative (N) effect on the various target variables (absence of an entry implies that the policy is not expected to make much difference one way or the other to the target variable in question).

The target variables have already been explained. We saw in Working Paper No. 31 how efficient factor and product markets assisted flexibility, by increasing resource mobilities, price elasticities and economic responsiveness generally. Similarly with the others listed in the table: we have shown each of these to contribute in varying ways and degrees to an economy's capacity to adjust. The 'instruments' listed in the left-hand column are, in fact, still rather broad types of actions that governments may take, with more specific illustrations provided in the next column. Hopefully these too are self-explanatory, although we should explain that by 'fiscal stance' is meant the extent to which the overall balance of government revenues and expenditures has a stimulating or dampening effect on economic activity.

To illustrate the use of the table, see line (c) - the taxation of fuel. This subject arose for many developing countries as a controversial policy issue following the very large increases in petroleum prices in 1973-74 and 1979-80: should governments also raise their taxation of this product? Assuming the country to be an oil-importer, the effect of an increase in such taxation will be to dampen demand for the product to some extent, and we have therefore marked this as having a positive effect on the balance of payments. More controversially, we have also marked it as having a favourable effect on the efficiency of product markets, for the reason that the tax increase would result in a final price for fuel that more accurately reflected its scarcity value and because it could improve incentives for the development of locally-produced alternatives to imported oil. However, we have suggested that this measure would tend to discourage industrialisation, because fuel and other energy costs are particularly important inputs to the manufacturing sector. We suggest also that this measure will impose social costs, for higher fuel prices will affect the costs to poor people of transport and lighting (kerosene).

To pick out another illustration, line (k) suggests that the decontrol of interest rates will raise factor market efficiency (for interest rates will now better reflect the scarcity value of capital), encourage saving (by offering savers better returns) and, by channelling this saving through banks and similar institutions, promote financial deepening. It also suggests, however, that the higher interest rates will tend to discourage investment, rendering some potential projects unprofitable. It would be tedious to go through the entire matrix in this way and these examples will perhaps suffice, but the reader might like to go through a few more examples. There are, however, a few points arising from the table which are worth spending time on.

IV.2 Points arising

Note first how rare it is for a policy action to be an unmixed blessing. Both of the examples just provided were expected to have some negative effects and that is typical of almost all the policy instruments listed, reading across the table. In some cases a policy instrument may have both positive and negative effects on the same target variable. Thus, in cell (m8) a currency devaluation may both improve macroeconomic stability by absorbing excess domestic demand and worsen it by raising prices (see the Working Paper No. 33 for a detailed discussion of the exchange rate). Similarly, in cell (p10) increased agricultural producer prices may reduce the welfare of the urban poor by raising food prices and improve the welfare of the rural poor by raising their incomes.

This mixture of effects underscores the complexity involved in economic policy-making. With few exceptions, policy choices are a matter of carefully weighing the positive and negative effects they may produce - a task made the more difficult by the large uncertainties which generally surround policy-making. It is rare for all the indicators to point to the same conclusion or even for there to be confidence about what the precise effects of a policy change will be. So beware the peddler of simplistic, single-policy solutions!

Table 2 does provide some exceptions to this complexity of results. The provision of economic and informational services (lines e and t) are recorded as having only positive effects, as are the maintenance and creation of the basic infrastructure - roads, communications, power, etc. These are expected to improve the efficiency of factor and product markets, incentives for private investment, industrialisation, the balance of payments, and so on. However, this points to one of the weaknesses of the matrix format, that it is silent on the efficiency with which these services are provided, or their quality. Often inefficiency rules: extension services which do not reach farmers with practical advice; roads built on political grounds with little consideration of the economic costs and benefits; statistics which are tardy and unreliable. In such cases, measures to improve the quality of public sector services are themselves to be considered part of the adjustment

Table 2: Illustrations of target variables and policy instruments for economic flexibility
(P = positive, N = negative effects)

POLICY INSTRUMENTS	EXAMPLES OF USE	Factor market efficiency (1)	Efficiency of product markets (2)	Enterprise & innovation (3)
<u>FISCAL POLICIES</u>				
Taxation	a. Investment incentives	N		P
	b. Tariff protection		N	P
	c. Taxation of fuel		P	
Expenditures	d. Food subsidies		N	
	e. Economic services		P	
	f. Social services	P		
	g. Infrastructure (maintenance & investment)	P	P	
'Fiscal stance'	h. Increased taxes (spending cuts)			N
	i. Domestic borrowing (non-bank)	N		
	j. External borrowing			
<u>FINANCIAL-MONETARY</u>				
Interest rates	k. Decontrol	P		
Domestic credit control	l. Manipulation of bank reserve ratios			
Exchange rate	m. Devaluation	P	P	
<u>ADMINISTRATIVE CONTROLS</u>				
Exchange controls	n. Restriction on capital outflows			
Price and wage controls	o. Minimum wage laws	N		
	p. Increased agricultural producer prices		P	
<u>LEGISLATIVE & INSTITUTIONAL</u>				
Relating to firms	q. Company law; anti-monopoly law; patent law		P	P/N
Relating to land tenure	r. Break-up of large estates		P/N	P
Public enterprises	s. Development Banks	P/N		P
Information services	r. Economic indicators	P	P	P

TARGET VARIABLES CHIEFLY AFFECTED

Saving	Private investment	Financial deepening	Industrialisation	Domestic macro stability	Balance of payments	Adjustment cost minimisation
(4)	(5)	(6)	(7)	(8)	(9)	(10)
	P		P P N		P	N
	P			N	N	P
	P		P	N	P	P
P		P		P	P	N
		N		P	P	
	P			P	P/N	
P	N	P				
	N	N		P	P	
				P/N	P	N
N	P				P	
N	N		N			P P/N
			P			
						P
	P	P	P			
	P			P	P	P

effort, given the large benefits expected to arise from the proper provision of these services.

A further point which should be noted from the table is the rather strong tendency for there to exist tensions between the pursuit of improved flexibility and the minimisation of social costs. Food subsidies are an obvious example. On the one hand, they are likely to reduce the efficiency of product markets by distorting relative prices, and to threaten domestic macroeconomic stability and the balance of payments through the large strains they place upon the government's budget. On the other hand, the subsidies will benefit those families which are net consumers of the subsidised foods. Removal of the subsidies can scarcely fail to hurt some disadvantaged groups, even though blanket subsidies are a notoriously inefficient way of aiding poverty groups. Similar tensions exist with the enforcement of statutory minimum wages: they reduce the efficiency of the labour market, discourage corporate saving and investment, and industrialisation - but they protect the living standards of some unskilled workers and their dependents which otherwise would be at risk. We return to the ways in which social welfare and economic adjustment may be reconciled later in this series of Working Papers.

We should finally note some of the other limitations of the policy matrix format. One is that all target variables and policy instruments appear to be given equal importance, which is far from being the case in reality. The difficulty is that relative importance can be determined only in the context of a concrete country situation. All are potentially of large importance.

Second, the 'examples of use' presented in the second column provide only a small sample of the total number of specific policy instruments available to governments and some of the examples provided are still aggregations. Thus 'increased taxes' (line h) leaves unsettled crucial questions about what kinds of taxes might be raised and what rate structures they might be given. The entry for 'tariff protection' similarly fails to draw attention to the crucial question of the structure of protection, which can have a major influence on the pattern of industrialisation and which typically discriminates against the domestic production of producer goods. If we were to list all the different specific policy instruments which the government could bring to bear on the task of adjustment, and all the decisions that present themselves concerning how these policies should be designed and executed, we would have a long list indeed.

It should also be recognised that many of the instrument-target relationships postulated in the table could be disputed, and rely heavily on this writer's understanding of how economies and policies work. More to the point, the relationships will vary from one national economy to another; the matrix is intended to be illustrative, not to lay down universal truths. To give but one more example, line (r) is rather positive about the effects

of land reforms which break up large estates. Some country experiences support that view, others do not. The country's socio-economic structures, its factor proportions, and the level of literacy among the peasantry would all have a crucial bearing upon the outcome, as also would the precise design of the land reform and the way it was implemented on the ground. Once again, we are reminded of the sheer complexity of policy choices.

IV.3 A comprehensive adjustment programme

To remind the reader of the complexities does not necessarily help him or her to an understanding of the specifics of adjustment policies, however. It might be useful, therefore, if we were to present in more concrete terms what a comprehensive programme of adjustment might look like. First, we shall imagine a country which has hitherto been pursuing an inward-looking strategy and has been run along 'command' lines, with extensive controls on prices, wages, interest rates, imports and capital movements, and extensive state participation in the productive system. We assume further that the country has serious balance of payments and inflationary difficulties, and an over-valued exchange rate. Per capita incomes have been static or declining for some time and savings and investment have fallen to low levels. Taken together these circumstances are perhaps rather extreme, but there are many countries which have possessed a substantial proportion of such attributes in greater or lesser degree. What package of policies might be brought to bear to improve the performance and flexibility of this economy?

In such a situation many of the required actions would be the negative ones of loosening existing controls in order to free up markets and improve incentives. Thus, the government would consider the abolition or modification of many of the controls listed above, although it would have to tread carefully in doing so, particularly when liberalising imports in the face of balance of payments difficulties. Also in the interests of greater competition and more efficient markets it would need to reduce the general level of protection - tariff and non-tariff - as well as reducing anomalous discrepancies in the extent of protection enjoyed by different producers. It may also consider introducing legislation aimed at preventing the misuse of monopoly power.

These actions should go some way to improve price incentives for economic flexibility but the government may wish to go further. In the face of an over-valued currency it should engineer a devaluation or depreciation of the currency - and one that 'stuck', in the sense of not being undone by inflation. Devaluation would increase the incentive to produce tradeable goods vis à vis non-tradeables. Where the government controlled the domestic prices received by exporters, or taxed these heavily, it should review its policies in order to ensure improved producer incentives - an action that would be made easier to reconcile with avoiding large budget deficits by the devaluation.

Bearing in mind the importance we attached earlier to the overall macroeconomic environment, the government would also need to ensure against running large budget deficits, for they would add more inflationary fuel, weaken the balance of payments and frustrate the needs of the private sector for credit by pre-empting much of it for government. The fact that macroeconomic stabilisation would also involve keeping the total expansion of credit under careful control gives added importance to avoiding large public sector borrowing requirements.

In order to reduce budget deficits, the government would therefore need to look hard at both its tax revenues and its expenditures. It would need to consider whether there were opportunities for new taxes which would not adversely affect incentives; and ways of improving the collection of existing taxes. In the face of overall budgetary stringency, it would need also to look hard at its pattern of spending, to reorient it towards those economic and social services likely to promote economic recovery; at ways of improving the quality of these services; and at ways of increasing the productivity of its own investment decisions, e.g. through improved project evaluation procedures. Mindful of the wastefulness of rent-seeking activities and of corruption, it would need further to consider ways of reducing the discretionary powers of tax and regulatory bodies, for it is by the exercise of such discretion that public servants assert bureaucratic control over private activities, creating delays and eliciting bribes. It would also want to have a critical look at the economic and financial performance of its public enterprises, rehabilitating or privatising the poor performers. Among other institutional initiatives, it might consider promoting the creation of new financial institutions, and the possibility of land reform.

There is an element of caricature in the above description, not the least for the simplifying assumptions that underlie it. We have, for example, ignored all constraints on the government's ability to formulate and implement such a wide range of policies in a short period of time, although in practice such constraints would likely stand in the way of a comprehensive programme. We have also left aside the objective of minimising the social costs of the adjustment, as well as more overtly political constraints on action: the likely reaction of powerful interest groups to some of the changes and the effects of these on support for the government. We have said little about the desirable sequencing of such a programme, or about the likely interactions between the programme components. The policy described is also ultra-orthodox. But caricatures can also illuminate, and the purpose of these last few paragraphs has merely been to provide the reader with more of a flavour of what specific policies may be involved in an adjustment programme.

In the face of the complexities of the real world, policy-makers need guiding principles and rules-of-thumb to aid them in their work. Our next task, therefore, is to examine what might be learnt from writings on the theory of economic policy and from

past experience which will throw further light on the design of policies for economic adaptation.

V. PRINCIPLES OF POLICY

V.1 Targets and instruments

We can start by looking a little more closely at the notions of 'target variables' and 'instrument variables' which we have been using. Beginning with **target variables**, Table 2 has already made explicit an important feature of the policy problem: that governments pursue multiple objectives. They wish to improve market efficiency, raise saving and investment, industrialise, and so on. However, as presented in the table, these are only subsidiary, or instrumental, objectives, selected because they will contribute to economic adaptation. Adaptation, in turn, will not be the government's only economic objective - economic growth and, perhaps, the redistribution of income are likely to be among the others - nor will the government's objectives be confined to the economic sphere. This then brings in the idea of multiple and hierarchical objectives, to which we will come back in a moment.

Turning to **policy instruments**, these can be defined as means controlled by the government of changing the behaviour of the economy. For some purposes it is useful to differentiate policies according to whether their effects are direct or indirect. The provision of, say, a road or the administration of rent controls are examples of instruments which operate directly on economic life. Examples of policy instruments which operate indirectly include attempts to discourage the consumption of luxuries by imposing heavy taxes upon them, or to encourage saving by raising interest rates. Indirect measures, by and large, work through markets and have their effects by altering pecuniary incentives; direct measures often work independently of the operation of market forces. It can be realised, therefore, that one of the features of the type of adjustment programme described a few paragraphs ago is that it represented a shift from direct to indirect measures. To introduce a further type of distinction, it can sometimes also be useful to differentiate between instruments which have an impact on a wide range of economic variables - the interest rate is an example - and those which are much narrower in their incidence, say an excise duty or an export licence.

The language of targets and instruments is at the centre of much of the theory of economic policy, which is particularly associated with the name of Jan Tinbergen.²¹ He developed a mathematical model of policy formation which arrived at an important practical conclusion: for a government to achieve multiple policy objectives it must use at least as many policy instruments as the number of target variables. Of course, this

²¹ See Tinbergen, 1955 and 1967. Spulber and Horowitz, 1976, provide a useful introduction to much of the policy theory literature.

result reflected the nature of the model he used and the necessity of exact equality between the numbers of instruments and targets falls away on alternative formulations. The Tinbergen rule nonetheless serves as a warning against trying to use just one or a few policy measures to achieve a multiplicity of objectives. Since adjustment programmes normally possess a number of target variables, it is appropriate that they should also bring a range of policies into play. Once again, we are warned against single-instrument solutions. To put the matter another way, if political or administrative constraints prevent a government from implementing more than a small number of policy changes then it can only expect to achieve a limited number of objectives.

V.2 Tradeoffs and adjustment costs

The pursuit of multiple objectives brings with it the potential for conflicts between them. This brings in the idea of **tradeoffs**, when progress towards one objective can be achieved only at the cost of a retreat from another objective: restricting bank credit may ease inflationary pressures but at the cost of reduced investment; protecting those who depend for their livelihood on some declining industry is liable at the same time to preserve existing structures of production and employment, retarding necessary structural adaptation. The rate at which it is necessary to sacrifice one objective in order to promote another is the rate of tradeoff between them. Tradeoffs are pervasive and further complicate the policy problem.

In principle, choices between conflicting objectives can be resolved according to their place in the hierarchy, or according to the weight which the government places upon each of them.²² Unfortunately, though, governments are rarely precise or consistent about their objectives, which leaves the resolution of tradeoffs a rather hit-or-miss affair. Political scientists are inclined to say that in such situations 'political logic' dominates 'economic logic'.

Although Table 2 indicates a potentially large number of possible tradeoffs, when discussing it we particularly drew attention to the tension between the pursuit of adjustment and minimisation of its costs. In fact, the idea of tradeoffs in adjustment policies is intimately connected with the concept of **adjustment costs**. The literature abounds with references to the costs of the adjustment policies of the IMF and World Bank, but most of these are rather loosely formulated and there is surprisingly

²² In formal terms, and given a specification of its own preference function, the government should settle for policies which will act on the various target variables so that the marginal rate of transformation is equal to its marginal rate of substitution. Such formalism is of little practical use, however.

little discussion of adjustment costs as a concept.²³ Analytically, there are different types of cost that may be identified.

There are first what might be termed 'absorption costs'. These arise in the common situation where a country's adjustment policies are addressed to improving an unviable balance of payments situation. Faced with a need to reduce a current account deficit, standard textbook theory tells us that the country must reduce 'absorption' (consumption plus investment) relative to income. In principle it is possible to achieve this by increasing income while holding absorption constant, but in practice - and in the short term - countries are likely to have to cut back on consumption and/or investment in the public and/or private sectors.²⁴ Such cuts can be seen as costs, resulting in lower consumption and/or investment levels than would otherwise have occurred. In a sense such costs are unavoidable in that they are part of the economic logic of the balance of payments problem, although they can be minimised by doing everything possible to maximise the growth of income.²⁵

In institutional terms, absorption costs arise more commonly in connection with the stabilisation programmes of the IMF, which is one of the reasons why so much controversy surrounds Fund programmes. Whether such costs are best understood as arising from adjustment *per se* is, however, a moot point, since they actually arise from the circumstances and policies which allowed absorption to get too far out of line with incomes in the first place. They might better be thought of as the costs of adverse shocks or past policy weaknesses.

²³ See, however, Corden, 1989, and Huang and Nicholas, 1987.

²⁴ See any standard textbook of international economics for an explanation of the absorption model of the balance of payments.

²⁵ The history of attempts to deal with the 'debt crisis' of the heavily-indebted Latin American countries after 1982 can be traced in these terms. The initial effort was focused on cutting absorption, and both consumption and investment were reduced. As a result there were major improvements in the trade balances of the debtor countries (necessary in order that they could make interest payments on their external debt) but at the cost of severely reduced living standards and investment levels. In the belief that such sacrifices were not sustainable indefinitely and could, in any case, prove counter-productive, from about 1987 international attention switched to 'adjustment with growth', with the intention of being able to ease up on the absorption variables. The 'Baker plan' of that year was the catalyst, although only limited improvement was achieved in practice.

A second category might be termed 'frictional costs'. These refer to losses of output, employment and consumption resulting from the shifts of resources from declining to expanding sectors that are intrinsic to economic adaptation. They arise because markets are imperfect. If they were everywhere perfect, all prices would be flexible, resources would be completely homogeneous and mobile, and adjustment would be instantaneous. However, many types of labour, capital and natural resources are highly specific in their productive employment. An irrigation system cannot be used in factories; a miner cannot instantly be converted into an hotel worker; even within agriculture a given ecological zone is not necessarily suitable for conversion from a traditional crop to another. Markets are imperfect in other ways, too. Prices are often 'sticky' in the downward direction, none more so than in labour markets, where there are fierce resistances to cuts in nominal wages even in the face of the decline of an industry (although they may be eroded by inflation). In the face of such conditions, structural adaptation will be associated with 'frictional' losses of employment and capacity utilisation - losses which may be large and persistent. Indeed, most of the discussion of adjustment costs in the OECD countries is about the unemployment that results.

A further category that might usefully be identified is what we can call 'distributional' costs. Of course, absorption and frictional costs affect the distribution of income because they are not spread across the population in a manner exactly proportionate to the prior distribution of income. But there would be distributional consequences even in the absence of the other two categories, for adaptation involves resource shifts between different industries which will employ differing factor proportions. Working Paper No. 31 showed that the long-term historical trend is in the direction of greater capital-intensity. Resource shifts thus give rise to differing groups of gainers and losers, whose short-term interests are in conflict with one another. This affects the politics of the choice and sustainability of adjustment policies, depending upon the relative political weight of the two groups.

Distributional costs might be said to arise when the value attached to the losses of those adversely affected exceeds the value placed upon the benefits of the gainers. Much of the discussion of the costs of adjustment are, in fact, about distributional aspects and, in particular, about the danger that the poorer groups in the population will be disadvantaged. Implicit here is the idea that a dollar's-worth of loss by the poor is not offset by a dollar gain by the rich, so that different weights are placed on the income changes.

We might finally notice the time factor in adjustment costs. Especially in the case of absorption costs, the government is faced with choices between reduced consumption and reduced investment, which boils down to whether consumption is reduced now or in the future. There is an ever-present temptation to push required reductions in absorption onto investment. This

is perhaps specially the case in the public sector, where governments find it very difficult to cut their current budgets (because that is likely to require layoffs of civil servants) and easier to cut back on their own capital spending. A similar choice arises with frictional costs: it is tempting to minimise these by slowing down the rate of change, subsidising industries that otherwise would decline, at the expense of the rest of the economy. In both examples, economic adaptation is retarded and costs are shifted forward to the next generation. Such inter-generational issues are closely related to the choice discussed earlier between positive and defensive adjustment strategies; our conclusion there in favour of a generally positive strategy implied an approach which avoids shifting the costs into the future.

In the low-income countries of which we are writing, however, this can be a harsh doctrine. As we showed in Working Paper No. 31 (p.42), poor countries have inflexible economies. This means that frictional costs are likely to be particularly severe. Starting from already very poor living standards, the temptation to shift costs into the future will be large - but the results of doing so will be to retard the very process of change upon which the improvement of living standards itself ultimately depends.

On the other hand, it would be quite wrong to view structural adjustment, wherever it occurs, as a zero-sum game, in which gains are offset by equivalent losses. Although it may sometimes seem that way in the short-term, the large long-term gains that can be won from successful adaptation cannot be too heavily stressed. In an historical perspective adjustment is a massively positive-sum game. In the end, the losers are those who do not adapt.

V.3 Choosing among instruments

Given the multiplicity of policy instruments available to governments, the further question arises of how they should select among them. This too is a neglected topic but a number of efficiency criteria can be suggested.²⁶ At least the following questions need to be asked about an instrument in evaluating its likely effectiveness:

- How large will the response of the target variables be to a given change in the instrument variable?
- How probable is it that the expected results will actually be achieved, and how quickly will they occur?
- Does the policy act upon the causes of the problem at which it is directed?

²⁶ Much of the following is adapted from Killick, 1981, pp.44-47.

- What are the resource costs of the policy?
- Is the policy selective in its application and flexible over time?
- What indirect economic effects will the instrument have and will they be positive or negative?
- In what ways is the public likely to react to the policy?
- What will be the socio-political effects?

We will elaborate briefly on each of these.

In the case of the magnitude of response, the general rule is to choose the more powerful. This is partly because low-income developing countries face typically large adjustment problems and therefore need powerful instruments if they are to be able to cope. There is the additional consideration that the public acceptability of a policy change is liable to depend upon the extent to which it represents a break with the past, with incremental changes better tolerated than large discontinuous shifts. To achieve a given change in a target variable a powerful instrument needs a smaller change than a weak instrument, thus aiding its acceptability.

Regarding the speed and probability of results, the advice to choose the faster-acting policies (other things being equal) needs no elaboration but the probability dimension needs a little more explanation. An important influence on the probability that a measure will achieve the desired results will be the ease with which it can actually be implemented. This is something to be considered already at the planning stage, for the more difficult the execution the smaller the probability of success. A second, more obvious, influence has to do with the state of knowledge: we may have only a hazy idea what the effects of a policy change will be, but greater ignorance may surround some instruments than others. On the whole this consideration also favours an incremental approach, for we are likely to have a better idea of the consequences of modifying an existing instrument - raising the income tax rate, say - than of introducing a new one.

Most policy measures are responses to felt problems. Hence, we can ask, does it act directly on the causes of the problem or does it merely suppress its symptoms, or compensate for them? The general rule is to choose policies that act upon causes. That may not always be practical, however - as in the case of problems emanating from the world economy. A government faced with a rise in import prices can do little about the causes of that and has to respond indirectly by measures that will boost foreign exchange earnings and reduce import demand. Similarly, it will not always be desirable to act upon causes. For example, a firm may possess monopoly power stemming from its superior ability to reap economies of scale. In this case the

BOX III. ATTENDING TO CAUSES: THE ASSIGNMENT RULE²⁷

Many policy interventions are directed at remedying the effects of some type of market failure, or distortion, in the economy. The assignment rule states that the best results will be achieved from that policy intervention which most directly addresses the original source of failure. This is because policy measures tend to introduce distortions of their own, and the further removed they are from acting on the original cause of the failure the more likely it is that they will introduce new distortions. Although this is a general proposition it has, in fact, mainly been taken up in the trade policy literature because so many arguments for protection are not addressed to failures resulting from the characteristics of international trade as such, and are instead intended to compensate for other types of distortion.

Take the well-known infant industry argument for protection. This argues that where a newly-created firm's costs are above internationally-competitive levels because it has yet to take advantage of learning-by-doing it should be protected, because after a while its costs will fall and it will then be internationally competitive. To be strictly valid, however, this argument has to show why this learning period cannot be anticipated and privately financed. To do so it is likely to be necessary to invoke some imperfection in the capital market. If indeed some such imperfection does exist, application of the assignment rule would result in adoption of policies that would directly address the capital market imperfection. A protective tariff is likely to be a sub-optimal policy choice, since it can only compensate for the capital-market deficiency at the cost of introducing new distortions: creating protection for older-established firms in the same industry which could not justify it, affecting relative prices and the distribution of resources between them, adversely affecting incentives to export through its influence on domestic cost levels and the exchange rate, and so on.

²⁷ See Corden, 1974, pp.28-31, for a lucid exposition of the assignment rule.

government will be wise not to discourage large-scale production but should instead erect safeguards against abuse of the resulting market power. Nevertheless, the rule of thumb is to choose measures that act on causes. It is a rule that derives more from common sense than economic theory, but there is a close affinity between it and the so-called 'assignment rule' developed in the theory of trade policy (see Box III).

The next of our efficiency criteria concerns the resource costs that its deployment will necessitate, with the general principle being to adopt the least-cost alternative. Almost all policies involve some use of government revenues, but some much more than others: a targeted food subsidy is likely to be far more cost-effective than a general subsidy, for example. Policies may impose resource costs on the private sector too. These may be minor and overt, as in the costs to employers of administering a pay-as-you-earn income tax system, or large and covert. Examples of the latter type might include, say, the running of a large budget deficit which is financed by borrowing from the banks and which 'crowds out' the credit needs of private producers.

The notion of 'rent-seeking' can also be brought in here, by which is meant activities intended to secure the benefits of monopoly power. The relevance here is that some types of policy instrument - particularly those which involve licencing and regulating - create scarcity rents which can bring large profits to those who can take advantage of them. Import licenses are an obvious example. Because the potential profitability is large, aspirants to these rents will utilise skills and other resources in order to take advantage of these opportunities. These efforts will thus absorb economic resources in a way which is unproductive in the sense that it does not add to total output, and this will impose an opportunity cost on the economy.²⁸ In this sense, a shift, say, from exchange controls to an active exchange rate policy may be thought of as a shift in the direction of greater cost-effectiveness in that it is likely to reduce rent-seeking activities, replacing licencing by price rationing. Policy interventions may also impose costs by creating distortions in the economy, reducing the efficiency of resource use. Strictly, this is not a resource cost, but the effect is the same, of reducing output.

Our next efficiency criterion is concerned with the selectivity and flexibility of an instrument. By selectivity we mean the extent to which its effects are confined to the furtherance of whatever objective the government is using it to further. By and large, selectivity is to be preferred because it reduces the risk of unintended effects and improves the predictability of the outcome. In the case of flexibility, what is intended here is the ease with which an instrument can be varied or discontinued over time. Some instruments are less flexible than others: it is fairly easy to alter tax rates in either direction; minimum wage regulations are flexible in only one direction; reforming institutions is notoriously slow work and frequent changes are likely to be undesirable. Other things being equal, then, the general rule here is to choose instruments which hit their targets in a selective manner, and to prefer those that are flexible.

This brings us to the indirect economic effects. Our discussion of Table 1 stressed the complexity of the ways in which policies interact with the economy. Even the most selective policies are liable to have effects on variables additional to the intended ones. An advantage of quantified, modelling approaches to policy-formation is that they increase our ability to predict these indirect effects. A positive effect is one that promotes some policy objective additional to the one that is the chief motive for introducing the measure; a negative indirect effect

²⁸ On rent seeking and other 'directly unproductive profit-seeking activities' (DUPs) see Krueger, 1974; Bhagwati, 1982; Bhagwati and Srinivasan, 1982; and Tullock, 1980. Bhagwati and Srinivasan place DUPs into two categories: those triggered by policy actions and those seeking to influence policy. They may also be divided into legal (lobbying) and illegal (bribery) activities.

is one that conflicts with other policy objectives. The general rule is obvious: choose the instrument that maximises the excess (or minimises the shortfall) of favourable over unfavourable indirect effects.

The importance of the ways in which the public reacts to a policy measure has already been raised in Working Paper No. 31 (pp.37-8), in discussing the delicate balance that governments must strike between flexibility and continuity in their policies. Modern economic theory has shown how the ways in which the public reacts to macroeconomic policies can render these impotent, as they learn to anticipate these and to protect themselves from their effects. An example is provided by the ways in which parallel markets spring up when governments try to control prices (or exchange rates, or interest rates) at below market levels, sometimes entirely subverting the government's intentions. If reactions to a policy are to be supportive rather than subversive that policy must be credible - people must believe it can work, that the government will enforce it and persist with it.²⁹ The main rule here, then, is that policy-makers need to take an explicit view of the ways in which people are likely to react to alternative instruments, to choose those that are least likely to spark a hostile or countervailing response, and to be concerned with the credibility of those instruments and with policies as a whole.

There are finally the socio-political effects. Many policies are chosen - or rejected - on non-economic grounds, often reasonably so since ministers have more things to worry about than just economic problems. In fact, any sharp distinction between economic and non-economic effects is rather arbitrary and tends to break down in practice, although it is convenient for present purposes. Expressed most generally, the rule here is to choose those instruments which will bring the maximum socio-political benefits or the minimum socio-political costs, all judged in terms of the values of society and the objectives of the government.

Circumstances will decide what type of consideration should be brought in under this heading. Among the most general we can include [i] the expected popularity, or otherwise, of the measure (closely related to the previous question of public response); [ii] its effect, if any, on the country's relationships with the rest of the world (might an export subsidy provoke retaliation, for example?); and [iii] its effects on personal liberty (sometimes used as an argument against direct controls).

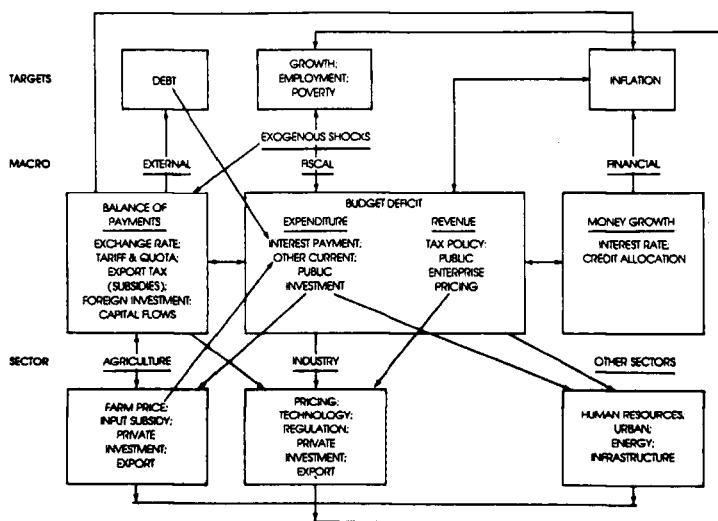
²⁹ Discussing import liberalisation, Edwards [1987, p.29] has stressed the importance of credibility. He points out that this, in turn, will be much influenced by the internal consistency of the government's policies, for if there is inconsistency people will see that the contradictions cannot be sustained, and he cites Argentina as an example.

V.4 Policies as a system

While the rules of thumb just presented, and the earlier discussion of targets and instruments, can provide useful guidance to policy makers, there is also a danger in these: that while each individual policy decision will be carefully considered this may divert attention from the overall design and coherence of the policies when they are taken together. This would be unfortunate.

One reason for saying so relates to the complexity of the ways a policy change will work its way through the economic system. One of the implications of this is that a given policy change may necessitate changes in other policies, as the economy responds. Thus, an increase in administered interest rates designed to encourage private saving (and thus to contribute to higher investment levels) may at the same time discourage investment in sectors to which the government attaches priority - say in agriculture - indicating a need to re-examine the taxation of profits or other policy changes which may counter the unwanted reduction in investment.

Figure A: The interaction of adjustment policies



Source: World Bank, 1988, p.34

A second reason for taking an overall view has to do with the incoherence that can easily result from a succession of *ad hoc* decisions, even though each decision may in itself have been carefully considered. Thus, analyses of countries' patterns of industrial protection commonly find very large variations in the levels of protection given to different industries - variations that cannot be rationalised in terms of economic priorities. The most common reason for this incoherence is that decisions about protection are often taken in response to individual requests for assistance. Unless there is an unusually strong and clearly defined set of guidelines governing such decisions, the end result is a series of decisions which do not add up to a consistent whole. A closely related consideration is that, if they are to have maximum effect, policies need to be mutually reinforcing, supporting one another. Thus, it is shown in Working Paper No. 33 that a currency devaluation may make little lasting difference to the balance of payments unless it is backed up by a variety of other policy measures. Other examples include the obvious need for close co-ordination of fiscal and monetary policies, so that, for example, a tightening-up of fiscal policies is not undone by expansionary credit policies. At a more microeconomic level, the desirability of co-ordinating agricultural pricing policies with the provision of extension and marketing services is an obvious example. One view of key interconnections is provided in Figure A, based on the experiences of the World Bank.

Another closely related reason for looking at economic policies as a system is the importance of the sequence in which policies are introduced, even though economics does not yet have very much to offer on this subject. The issue of sequencing has arisen, for example, in controversies about the timing of trade liberalisation, as is discussed in Box IV. Even though liberalisation can be seen as part of an overall effort to strengthen a country's trading position, its premature introduction can undermine the whole process by sparking an import-led payments crisis. This is but one of a number of policy areas in which introducing policy measures in the 'right' order is important.

So although each policy decision must be carefully considered, part of this consideration must be to see how it fits into the overall design of the government's economic policies: is it consistent with, and helpful to, other policies? does its effectiveness depend upon making additional supportive policy changes? is it likely to set up reactions in the economy which necessitate further policy decisions? is this the right point in the sequence for the policy to be introduced? Indeed, our earlier discussion of policy strategy implied that such an overall view would be taken, for a strategy consists of an internally consistent package of measures applied consistently over time.

BOX IV. SEQUENCING TRADE LIBERALISATION³⁰

There remain disagreements between authors in the literature on the sequencing of trade liberalisation, although all agree that the best solution depends upon country situations and that the approach should be flexible. There is, nevertheless, substantial support for the view that liberalisation should follow a four-stage timetable:

- **Stage 1: stabilisation**

This is likely to include a large nominal devaluation, with complementary tight fiscal and monetary policies to counter inflation, intended to increase the profitability of exporting and discourage imports. These policies will need to be maintained during subsequent phases, though for countries with low inflation and realistic exchange rates only minor subsequent currency depreciations should be needed.

- **Stage 2: liberalisation of domestic factor markets.**

The principal elements of this phase may include lifting wage controls to liberalise the labour market; financial sector reforms to strengthen the credit market, to ensure adequate investment and working capital for export expansion, to prevent import-competing firms which become "unprotected" from excessive domestic borrowing if this would jeopardise the financial system; removal of investment controls; and reduction of price controls.

- **Stage 3: import liberalisation.**

This may be in two steps. The first could consist of the removal of quantitative import restrictions and their replacement by a rationalised tariff system which reduced the extremes in tariff rates. The second step could involve reduction of tariffs by cutting the highest tariffs first and others later.

- **Stage 4: relaxation of controls over capital movements.**

This type of sequencing is not without disadvantages, including political ones. Waiting until the first two stages have been completed may give lobbies opposed to import liberalisation time to organise, although the time involved in the sequence may also provide opportunities for countervailing exporting lobbies to emerge and become organised. In any case, the economic consequences of neglecting the question of the order in which changes should be introduced - or of getting it wrong - can be large. Thus import liberalisation without first going through Stages 1 and 2 will risk creating a balance of payments crisis, for an over-valued currency and domestic price level will make imports cheap; and the potential for exporting and import-substitution created by devaluation will not be fully realised if factor markets remain highly imperfect.

Similarly, relaxation of capital controls must await the other measures. If not, high domestic interest rates and the need for investment by exporters may suck in foreign capital, push up the real exchange rate, and create a recession in tradeable goods industries. Premature liberalisation of exchange controls may also accelerate capital flight. Both events will undermine trade liberalisation.

³⁰ Based largely on Edwards, 1987; Mussa, 1987; and Wolf, 1986.

V.5 Implementation and sustainability

To our efficiency criteria for the selection of policies we could have added another: is it likely that the policy will be implemented successfully and sustained over time? In a sense a decision in favour of some policy is the easy part of the process. It then has to be executed in ways which preserve the policy-makers' intentions. Its success is also likely to depend on whether it will be persisted with over time, after opposition to it has had the chance to emerge and to organise.

Although we treat them separately, there are strong connections between the implementation and sustainability considerations. Thus a government which is 'soft' is likely neither to implement well nor to persist in the face of opposition. The prospects for both will be influenced also by the circumstances in which the policy was decided in the first place. If, for instance, it is an action taken reluctantly in crisis conditions or if it is forced on an unwilling government as a condition for an international credit, the odds against faithful and sustained execution are rather poor. Nonetheless, it seems preferable to treat them separately. Implementation can be regarded as being more of a bureaucratic, administrative matter - the domain of the civil service - which may prevent a decision being given practical effect, or distort the intended results, or entirely negate it. Sustainability belongs more in the political domain and relates to the possibility that a measure will be abandoned or reversed.

Dealing first with implementation, difficulties of two types can arise: those charged with the execution of a policy may be simply unable to cope with the informational and administrative demands which it creates; and those responsible for, or influential in, the administration of a measure may deliberately set out to thwart the intentions of the 'policy-makers' because they see their interests as threatened by it or for other reasons do not agree with it. In the first category, there are many examples: expenditure taxes too complicated to enforce properly; comprehensive price controls which require vast amounts of information and much manpower to administer and enforce; labour or industrial safety laws which would require an unrealistically large inspectorate; and so on. There are many examples in the second category also: import liberalisation which threatens to reduce the income which some officials can collect through bribery; agricultural services intended to benefit poor smallholder farmers that are captured by the well-to-do élites; credit institutions intended to encourage small-scale business which channel much of their funds to big business; etc., etc. It is often at the implementation phase that groups or individuals can influence who gains or loses by a measure, so the administrative process can become an arena in which special interests are pursued, with an obvious risk to the intentions of the 'policy makers'.

How to safeguard against these pitfalls? The most important advice is that implementation aspects should be explicitly

included in deliberations leading to choices between policy alternatives. To leave it as something to be worked out afterwards is to court the choice of policies which will not be successfully executed. However, it is possible to go beyond this general principle to suggest some further rules of thumb. These can be thought of as augmenting the efficiency criteria set out earlier.³¹ A policy instrument is most likely to be effective if it meets the following conditions:

- [a] The **objective** it is intended to further should be clearly and precisely specified. The notion of implementation presupposes an agreed yard-stick against which we can measure actual results.
- [b] The chosen instrument should have **simplicity**. By this we mean the number of agencies, offices and individuals involved in the implementation task and the levels of skill they will need to employ. The larger the number of people and agencies and the greater the required sophistication, the bigger the risk of delay and distortion. Co-ordinating the activities of a number of agencies is especially difficult, so the use of multiple agencies should be avoided whenever possible.
- [c] It should be possible to administer the policy within an already-existing **institutional and bureaucratic framework**. When this is unfeasible, explicit provision should be made for the creation of whatever special administrative capability the measure calls for.
- [d] Decision-makers should clearly specify where the **responsibility** lies for carrying the policy into effect. It is all too easy for this to be taken for granted and for there to be no clear identification of which person, or agency, is to carry out the policy.
- [e] Decision-makers should be aware of the **interests and motives** of those who will be involved in implementation. A measure that cuts against the interests of those who are to carry it out may be doomed unless special care is taken.

This last point may be of particular relevance to adjustment policies because we have suggested at a number of points that these are likely to include the substitution of market measures for administrative controls and discretionary actions. At the least, civil servants are liable to see such changes as reducing their power and influence; they may well also see them as diminishing their access to scarcity rents, through corruption and other means. In other words, there may be particular

³¹ This is taken from Killick, 1981, p.50. For a stimulating survey of much of the ground covered by our discussion of implementation and sustainability see Grindle and Thomas, 1988. See also Lamb, 1987, on the institutional dimensions of the topic.

difficulties in the way of successfully implementing liberalising measures. On the other hand, such measures - and the shift from administrative to market measures generally - will, once in effect, place far fewer demands on the public administration: compare the bureaucratic needs of wide-ranging import controls and of an active exchange rate policy.

What, next, will determine the sustainability of a measure? Probably the most decisive influences will be the ways in which a policy affects the interests of the public, how the gains and losses are spread across society, and the strength of the government *vis à vis* other centres of power in society (discussed in Working Paper No. 31 - see pp.36-7). If the bulk of the population regards itself as having been harmed by the measure, or if the losses are concentrated particularly in powerful groups in society, it will need a determined or resourceful government to persist. This is one of the difficulties of measures adopted by heavily indebted countries to avoid debt default: their citizens perceive their own interests as being sacrificed to those of foreign creditors, even though the government may be convinced that it is in the national interest to avoid default.

The political institutions and traditions of a country will also have a bearing on sustainability. The last chapter touched on the proposition that dictatorial governments are necessary for the successful pursuit of adjustment policies and concluded that this confuses dictatorship with strength. Some dictatorships are weak, some democratic governments are strong. But a government which is in constant fear of overthrow, governing within a system which does not have deep roots in the loyalties of the public, whether or not it is democratically elected, is unlikely to win prizes for persisting with unpopular policies.

As already hinted, the circumstances in which a policy is adopted are also likely to be influential. Although this is admittedly more of an untested hypothesis, it seems reasonable to believe that policy reforms that have gestated gradually, have been discussed with interested parties and developed within existing institutions, and have been subjected to careful weighing of *pros* and *cons* stand a better chance of being successfully implemented and sustained over time than measures hastily put together in response to a crisis. Unfortunately, political realities are such that it often takes a crisis to elicit tough decisions!

A closely related point concerns the government's sense of 'ownership' of the measures in question. In the 1980s many of the 'adjustment programmes' adopted by developing countries were initiated by agencies such as the IMF and World Bank, and governments not uncommonly regarded the measures have having been forced upon them as conditions that had to be satisfied in order to secure urgently-needed loans. In such circumstances, there is likely to be little sense of ownership and it is not surprising if governments quietly drop (or negate) such measures

as soon as they get the chance.³² Relatedly, a government risks losing popular support if it is perceived by the public as following policies forced upon it from outside, thus reducing its legitimacy and the likelihood of sustained implementation.

V.6 A conclusion

In the last few pages we have presented rules of thumb by which the comparative efficiency of alternative policy interventions may be assessed and to safeguard the successful implementation of the measures chosen. In view of the complexity of instrument-target interrelationships and the inter-connectedness of different policies, we have also urged a 'systems approach', in which policies will be viewed as a consistent, mutually-supporting package. In doing so, we have opened ourselves to the charge of naïvety. Arguably, policy-making processes can never meet this ideal because of the many interest-groups that will have an influence on decisions, ministers' needs to balance these and to maintain their own perceived legitimacy, and the uncertainties and instability of political life - in short, because 'politics isn't like that'. Contrast our model with the following account of actual policy-making in an un-named African country:³³

A consistent and timely response to the deepening crisis was impeded by the fragmentation of information and decision-making. All major decisions... are visibly concentrated in the person of the Head of State, but many other decisions are taken in a dispersed, haphazard way throughout the administration... What planning has taken place has largely been in a formal bureaucratic sense and rarely linked to what has actually to be done to make what is planned materialize... economic priority is granted to short-term political considerations, often in a disconcertingly erratic manner.

Certainly, policy making in practice tends to be crisis-induced, *ad hoc* and highly political. Nevertheless, the fact remains that policies will not be fully effective unless they are well designed - and, in the end, politicians' popularity and security will be strongly influenced by the effectiveness of their economic policies. It is therefore important that economists who advise or influence governments should urge the need to look

³² The World Bank's 1988 review of its experiences with structural adjustment lending found programme implementation to be strongly correlated with the extent to which governments had played a leading role in designing the programme, and identified this sense of ownership as a prerequisite for future such lending.

³³ Quoted by Lamb, 1987, p.18.

at policies systematically, although economists need also to tailor their advice to political and bureaucratic realities.

VI. CAUTIONARY WORDS

VI.1 The nature of the state

What was hinted at in the last few paragraphs was a tension between how economists have in the past viewed the state as an economic agent and how governments actually behave. The view that we suggested was naïve conformed to what has been called the 'rational actor' model of policy formation.³⁴ This sees governments as motivated by a collective desire to optimise social welfare through the careful analysis and anticipation of problems and the choice of technically optimal policy solutions. Of course, as citizens economists know that the reasons why governments adopt policies, and the ways they get chosen, are less simple than that and that there are many constraints acting upon governments. Nevertheless, the basic premise of most writings about economic policy is that governments see themselves as promoting the general good of the public, by promoting growth and development, trying to ensure that resources are used efficiently, preventing excessive inequalities in the distribution of income, and so on.

Against this basically optimistic view, others have presented less encouraging views of the state.³⁵ Some view the state as analytically separable from society and as having its own interests: maintaining its own power *vis à vis* society and seeking to maximise its independent freedom of action; and promoting the economic interests of the *élites* which control or dominate the state. Within this orientation there is an influential body of writings on African political systems in which the state is described as 'patrimonial'.³⁶ By this is meant a system of personal rule based on communal, or ethnic, ties. On this view the state becomes penetrated by personalised relations operating to satisfy individual and communal aspirations at the expense of those functions of the state that would more widely be accepted as legitimate. Profits accrue to those who can manipulate the instruments of the state, rather than through production, but this creates a self-reinforcing spiral of political and economic decay. Development, and the economic adaptation on which it depends, are frustrated.

³⁴ The phrase is from Allison's classic 1971 study of the Cuban missile crisis.

³⁵ See Grindle and Thomas, 1988, for a valuable, brief sketch of alternative models of policy choice.

³⁶ See especially Sandbrook, 1985 and 1986; also Jackson and Rosberg, 1984. Beckman, 1988, provides a brief summary and critique of their position.

From models such as these, it is a short step to the positions of those who see the state as downright predatory on the general public (and the economy).³⁷ In formal terms, this sees the state as using its legal monopoly over the use of violence to maximise the revenues or 'profits' of government, in the interests of those who control the machinery of state. Or in the starker language of a political analyst [Sandbrook, 1985, p.41]:

At the nadir of this spiral lies chaos. A fictitious state of armed men detaches itself from society and preys upon a dying economy.

Nor is this view a mile away from the Marxian position: of politics as a manifestation of class conflict, in which the primary function of the state is to perpetuate the economic and political dominance of the ruling class.

All the views just outlined have in common a denial that governments are principally motivated by a desire to pursue the public interest, or even that they will see it as in their interests to pursue it. To the extent that this denial is valid, it must condition our espousal of the use of public policy to promote adaptation and other economic objectives. Indeed, many of those who belong to the sceptical schools just summarised urge an only minimal role for the state, leading to the 'Kahler paradox' of using the state - their only instrument - to change policy in a less statist direction [Kahler, 1988, p.29].

It can hardly be denied that the sceptics have a point. We can all think of countries which one or other of these descriptions fits well. Some readers will no doubt be living in countries where the state is seen by many as an instrument of oppression and economic exploitation, and where there can be little confidence that 'adjustment policies' will not be perverted to protect or favour the interests of a minority. At the same time we should not plunge too deeply into gloom. For one thing, countries do differ a great deal; no single model can cover them all. In some it is difficult to see a way forward, failing a revolution. In most the position is less desperate, and in some there is wide support for government economic policies. Moreover, many economies do make progress and the evidence does not support those who argue that the benefits of this are invariably concentrated on a small élite to the exclusion of most people.³⁸ Rather than trying to fit governmental behaviour into a single 'pure' model of political behaviour, it is reasonable to think of policies as an outcome of conflicting motivations, pressures and interests. Bad governments that run down the economy are apt to be removed;

³⁷ See Lal, 1984; also Wellisz and Findlay, 1988.

³⁸ See Bigsten, 1983, chapter 5, for a survey of the evidence.

the worst policies and practices do eventually tend to generate counteracting forces.³⁹ In many countries, there is scope for using the instrumentalities of state to promote adjustment. What we must learn from the sceptics, however, is that we should not expect too much of governments and that where a decision on a policy intervention is fairly evenly balanced their warnings may predispose us to preferring to avoid the intervention. By generally shifting decisions away from the state and towards market mechanisms, the types of adjustment programmes that are associated with the IMF and World Bank do reflect a greater distrust of the state.

VI.2 Big problems, weak instruments and foreign aid

Remaining in a cautionary mood, we should also be careful about the natural human tendency to believe that where there is a problem a solution also exists. The adjustment problems of many of the countries that are the concern of this book are very severe, while the policies available to their governments are often weak. For reasons outlined in Working Paper No. 31, the least developed countries will tend to have the most inflexible economies and the 'softest' governments. A narrow tax base inhibits use of fiscal policies. A shallow financial system inhibits the successful use of monetary policies. The changes in price incentives required in the face of small short-term elasticities may be too large to be politically acceptable. The government and its civil servants may be unable to implement laws and regulations intended to promote flexibility.

In countries whose economies have already experienced a major deterioration - where production is stagnant, living standards declining and savings low, where the black market rate is only a fraction of the official exchange rate, where other price relativities are also severely distorted, where local industry is propped up by high levels of protection - there is likely to be a particular problem of transition. It is easy to see that major changes are needed, and there may be a fairly clear idea of what the desirable end situation should be, but how to get from here to there? We return briefly to this question in Working Paper No. 33, but it must be admitted that economics is largely silent on transition paths, for it is mainly concerned with marginal changes, not large discontinuities. The problem is partly technical - the design of optimal transition paths - and partly political - the management of the opposition and tensions that the transition is bound to create.

In the face of the difficulties just described governments may simply be unable to cope, however well intentioned they may be.

³⁹ Thus, Beckman, 1988, argues against Sandbrook and others that the misuse of the state which they describe is helping to create a bourgeoisie with some power and nationalist credentials which has a strong motivation to prevent any collapse of the modern economy.

The magnitude of the problems they confront may be disproportionate to the instruments available to them, and the quality of their leadership may not be up to sustaining adequate policies through the transition until the economic results begin to be enjoyed. In the end sheer desperation will throw up radical policy changes, but it is not uncommon that things have to get worse before they get better - with all the human suffering that that entails.

The force of these remarks and the difficulty of successful adjustment policies will be all the greater in the absence of supporting finance from the rest of the world. We will conclude by briefly considering the role of foreign aid, for it is sometimes asked why aid for adjustment policies should be necessary since these policies are, in any case, in the interests of the country in which they are being adopted.

In the light of the above discussion, the case for financial support can be couched in terms of easing the period of transition, reducing the social costs of adjustment and reinforcing the political sustainability of the process. Particularly in low-income countries, response to changed relative prices and other policy stimuli is liable to be slow and initially small, so the transition is likely to be lengthy. Saving is likely to be low in poor countries experiencing economic difficulties, but structural adjustment necessitates major investments in the productive system and its supporting infrastructure. Aid and other forms of foreign capital can permit higher investment levels by supplementing domestic saving.

Countries faced with severe shortages of foreign exchange will need somehow to finance the transition, until responses to the policies begin to strengthen the balance of payments. During that transition imports will be needed to provide raw materials and spare parts to the productive system, to provide incentive goods to consumers, and to accommodate the needed investment. Aid in the form of free foreign exchange - as contrasted with aid that is swallowed up by meeting debt servicing obligations - can thus play a key role in easing the transition.

External assistance can also provide governments with more resources with which to cushion the poorest against the adverse effects of their policies and/or to buy off the opposition of key interest groups, thus helping politicians to persevere with the policies without too greatly endangering their own survival. Assistance, then, has a key role to play and its absence is liable greatly to increase the difficulties of successful adjustment policies in low-income countries facing major economic difficulties. It is for this reason that the stagnation in aid flows that has occurred in the 1980s - and the limited resources of the IMF and World Bank - have been the subject of much concern. We return to this topic in Working Paper No. 36, but our earlier discussion of a government's 'ownership' of externally-assisted adjustment programmes has already introduced the idea that aid can bring additional

difficulties of its own. The main burden of this section, however, is to emphasise the difficulties in the way of successful adjustment policies in many low-income countries and to warn that the task may be beyond the capabilities of some governments unless their efforts are reinforced by external finance.

VII. SUMMARY

This Working Paper has been wide-ranging, seeking to deal with a variety of general issues arising in the design of policies for adaptation. Let us now try to pull the threads together.

We started by considering what was the desirable role of the state in the pursuit of flexibility *vis à vis* market mechanisms. We pointed out that there is a well-established body of theory on ways in which markets fail, but that recently economists have been paying more attention to state failures, or to the costs of policy. We suggested a neutral, pragmatic solution of allowing the balance to be determined by the comparative advantages of the private and public sectors, balancing the costs against the benefits of any potential policy intervention. Application of this rule would leave much scope for judgement and disagreement but we suggested that application of the comparative advantage rule would show that the nature of state interventions was likely to be more important than the extent of them.

We turned then to consider certain fundamental strategy choices that have to be made when approaching the design of adjustment policies. The first was between positive, passive or defensive approaches, where we suggested that the choice was less wholly in favour of a positive stance than might have been supposed, that it was a matter of striking a reasonable balance between the advantages and costs of change but that a relatively positive approach was the most likely to facilitate successful adaptation.

However, we suggested that the 'big' choice was between relatively open- or closed-economy approaches - a choice that would have many ramifications for the structure of the economy and for the design of government policies. Our conclusion in favour of 'price-neutral openness' was strongly influenced by the small size of the economies about which this series of Working Papers is concerned, but balance of payments and efficiency considerations also weighed - as did the evidence on the effects of openness of economic performance. However, we qualified this conclusion in important ways, particularly by urging the need for those dependent on primary products to diversify their exports into lines facing markets with higher income elasticities of demand.

A final strategic question concerned whether or not the state should take on an activist role *vis à vis* markets in pursuit of the adaptive economy. We noted that the prior choice between open- or closed-economy approaches had a strong bearing on this question and concluded for an activist state which, however, works with and through market forces rather than against them; which establishes supportive relationships with the private sector; and which places a large weight on the avoidance of major macroeconomic disturbances.

Our next task was to consider the policy instruments available to government in pursuing adjustment, how these relate to policy objectives and how a policy package might be chosen. A target-instrument matrix was presented, which illustrated the range of policies that might be employed and how they might influence the various 'target variables', and which demonstrated the inherent complexity of the task of designing policies. The existence of multiple objectives introduces the notion of tradeoffs, and this brought in the concept of 'adjustment costs'. These we classified into absorption, frictional and distributional components and we also pointed out a generational dimension, relating to the extent to which costs are postponed into the future.

Given the availability of many potential policy instruments governments need criteria for selecting among them, and we suggested a number of rules-of-thumb. Other things being equal we suggested choosing those policies which:

- had the most powerful impact on the target variables;
- are the most probable to succeed and bring the quickest effects;
- act upon the causes of the problem, whenever possible;
- are selective and flexible;
- maximise the excess of favourable over unfavourable indirect economic and socio-political effects;
- are most likely to evoke supportive public responses.

We went on to consider some supplementary rules intended to enhance the probability that the chosen policies would be successfully implemented and also stressed the importance of taking an overall view, of seeing policies as a whole. We pointed out, however, that a 'rational actor' view of the policy-making process was implicit in our recommendations and contrasted this with more pessimistic views of the nature of the state as an economic agent. To the resulting caution that we should not expect too much of the state we added two further cautions: that in many low-income countries the magnitude of the adjustment problems they face are large relative to the strength of the policy instruments available to them; and that this difficulty will be all the more severe in the absence of adequate supporting finance from the rest of the world.

Having thus skimmed rather lightly over a large expanse of water, we should next dive a little deeper into the details of adjustment policy. Working Paper No. 33 therefore takes up a number of specific policy areas, drawing on the principles presented above.

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