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Working Paper

36

PROBLEMS AND LIMITATIONS OF ADJUSTMENT POLICIES

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 policies in the adaptive economy

36 Problems and limitations of adjustment policies

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 invaluable assistance.

CONTENTS

The preceding Working Papers in this series have focused on defining the need for structural adaptation, exploring the nature of an adaptive economy and exploring the role that economic policies can play to promote adaptability. In this concluding Working Paper we will try to place adjustment policies in their wider context and, in so doing, to tie up some of the loose ends that have been left dangling.

We have so far largely been writing about adjustment-in-one-country, even though the economies with which we are particularly concerned are heavily reliant on world trade and payments. Part I below asks whether adjustment-in-one-country is feasible, exploring whether the global economic environment is consistent with the adjustment efforts of individual developing countries. A closely related set of issues, which we have also thus far rather neglected, concerns the policy 'conditionality' of the major international financial institutions, particularly of the World Bank, with which structural adjustment became so closely associated in the 1980s. The pros and cons of that are the subject of Part II.

A further contextual subject which we have so far avoided concerns the connections between structural adaptation and poverty. This and its implications for policy are the subject of Part III, which also looks, more briefly, at the implications of adjustment policies for the protection of the environment. Finally, in Part IV we take further a matter which has already emerged as central to our concerns: the politics of adjustment.

I. THE GLOBAL ECONOMIC CONTEXT

I.1 Limitations of adjustment-in-one-country

It is obvious that if objectives are to be achieved efficiently economic policies within a country must be internally consistent. This is no less true for the world economy as a whole. The limitation of designing adjustment-in-one-country is that developments in the global economy and the actions of other governments may frustrate the intentions of the adjusting country. For example, the export-promotion efforts of individual countries must, in sum, be consistent with the expansion of world markets for their goods. There must similarly be an equation between the amount of international finance needed in support of adjustment efforts and the supply of such finance. Unfortunately, there is no assurance of such global consistency in the absence of effective international policy co-ordination.

Working Paper 31 (see Table 3 and accompanying text) has already described the powerful influence of global economic conditions on small low-income countries, chiefly transmitted through conditions on world markets for goods, services and capital, and exerting a particularly strong influence through movements in terms of trade, in capital flows and in world interest rates. We also saw there that various major trade and financial variables have exhibited severe instability in the past decade.

The context of the discussion in Working Paper 31 was to show the types of international shocks and trends to which developing countries are vulnerable, increasing the desirability of having flexible economies and policies. Does this mean that these external influences have to be treated as givens, as brute facts to be adjusted to? In some degree, yes. We showed, for example, that much of the adverse long-run trend in primary product prices was the result of fundamental changes that have been occurring in the structure of world demand. There is not much that policy can do about that. In other areas there is a good deal more that could be done, for some of the adverse conditions faced by developing countries are the result of the policies of industrial countries and the multilateral institutions which they control. In principle, those policies could be changed.

The rules and policies which have regulated the international economy in recent decades have been far from even-handed as between rich and poor nations. There are a number of asymmetries, with the resulting injustices leading to - now largely abandoned - developing-country calls for a 'new international economic order'. The chief asymmetry which concerns us here relates to the process of adjustment itself. If we view the global economy overall, total imports must add up to total exports and if one group of countries has a balance of payments deficit this must, arithmetically, be matched by an equivalent surplus in the rest of the world.[1] In this case, if the payments imbalances are to be removed corrective responses must be taken by both

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[1] Unfortunately, world payments statistics do not add up this way because of errors, omissions and differences in measurement in national statistics. By 1988 this statistical discrepancy was no less than $78 billion in the balance of payments reporting of the IMF. But the principle referred to in the text remains intact and the statistical discrepancies in no way justify the asymmetry complained of.

deficit and surplus countries, for if surplus countries protect their surpluses the corrective actions of those in deficit are liable to be frustrated. One of the weaknesses of the world economic system as it has evolved, however, is that adjustment has come to be viewed primarily as something to be undertaken by deficit countries, with no equivalent pressure for action on surplus countries.[2]

The essential problem here is one of unequal bargaining strength, for while countries with deficits they cannot finance have little option but to take corrective action, there is no equivalent force acting upon surplus countries. Thus the official historian of the IMF [de Vries, 1987, p.284] has noted that:

> *Since 1977 only developing [country] members have used the Fund's resources and there is an understandable perception of asymmetry between developing and industrial country members in that the conditionality applied to the use of the Fund's resources has significantly affected developing members, while surveillance [of policies] under Article IV . . . seems to have had little practical effect on the large industrial members.*

One consequence of this is that it tends to impart a deflationary bias to the world economy, with austerity policies in deficit countries unmatched by expansionary policies in persistent major surplus countries, such as West Germany, and with a high proportion of the costs of this bias thrust upon peoples in developing countries ill able to afford them. The post-1982 responses to the debt crisis could be interpreted in a similar way, with the rules of debt renegotiation being written by the creditor countries in only thinly-disguised pursuit of their own national interests, again leaving a distribution of the costs of renegotiation skewed to the disadvantage of the debtor nations. It was only at the end of the decade that more even-handed debt initiatives began to be introduced.

Another consequence of asymmetry was a marked discrepancy in the degree of policy rectitude expected of different country groupings. We have already drawn attention to that in Working Paper 34 in connection with agricultural pricing policies, with industrial country governments urging on developing countries the merits of the border-pricing principle while flagrantly departing from it themselves. Another example is provided in Box I, concerning energy pricing. More generally, one of the less edifying features of the international scene in the 1980s was of the government of the USA preaching through the IMF and in other ways that developing country governments must bring their budgets under control and reduce macroeconomic imbalances while at home it was running large and widening budgetary and payments deficits. This is not to deny that genuine adjustment has been occurring in OECD countries. There were, for instance, major changes in the efficiency of energy consumption following the oil shocks of 1973-74 and 1979-80. But too often the response has been defensive, in the sense described in Working Paper 32 and as illustrated in Box I, seeking to slow down the pace of change and thereby to reduce its social and political costs. The metal processing industries provide an example both of the defensiveness and of the

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[2] Deficit countries whose currencies are nonetheless widely used as an international means of payments are, however, exempt from these pressures to adjust so long as the rest of the world is willing to continue to accept more of its currency in sufficient volume and in that way to finance the payments deficit. The USA - the biggest deficit country of them all - is the chief beneficiary, of course.

costs this imposes on developing countries, for in this industry reluctance to close down uneconomic plant has contributed to low worldwide utilisation rates and depressed world markets for metals.[3]

BOX I. DOUBLE STANDARDS ON ENERGY PRICING [4]

When Western aid agencies provide aid loans or grants for energy projects in developing countries it is customary for them to specify that recipient governments should follow pricing policies that (a) ensure the financial viability of the agency, by yielding a positive rate of return on assets, and (b) are conducive to economic efficiency by being based on border prices (see Working Paper 34 on the border pricing principle). As with industrial-country agriculture so with energy pricing, however, it is often a different matter when it comes to their own policies.

For example, the succession of Conservative administrations which governed the United Kingdom throughout the 1980s espoused stout adherence to market solutions and through its aid to developing countries was an advocate of applying the type of policy described above. In its policies toward public sector energy pricing in the UK, on the other hand, it required the Central Electricity Generating Board - then the principal agency in the electricity supply industry - to purchase coal from the nationalised British Coal Corporation at prices which in 1982-87 were only once less than 25% above world market prices and which averaged over 30% more. Moreover, for much of the period the CEGB was not permitted to import more than 1% of its total coal needs.

The basic problem was that the British coal industry, despite the closure of uneconomic pits and considerable improvements in productivity and cost structures, was not competitive internationally in this period. Had the CEGB been permitted to buy freely at international prices, the coal industry would have been hard hit and many additional mines would have had to be closed down. This would have had grave effects in the communities based around uneconomic mines and would have caused additional job losses in a period of already high unemployment, often in regions where unemployment was particularly severe.

In short, the British government consistently over-rode viability and efficiency rules by policies designed to minimise the social and political costs that would be incurred by a more drastic pace of re-structuring in the coal-mining industry. In doing so, it probably had strong public support and may well have been justified in humanitarian terms. To avoid the criticism of applying double standards, however, it needed to be no less understanding of similar actions by governments in developing countries - an understanding that was not always evident.

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[4] Based on MacKerron, 1988.

Another feature of that decade was the retreat from international co-operation. The 'conservative revolution' which occurred in the major industrial countries brought into

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[3] See Carnegie, 1986, p.16, who comments that in the industrial countries unions, communities and governments have supported measures to continue uneconomic operations driven by a desire to maintain employment and export income, helping further to depress the world markets on which many developing countries depend.

power governments which demonstrated a willingness to place (often rather short-term) national interests above international co-operation, and a faith in the virtues of world trade and capital market mechanisms over the more interventionist approaches to international economic co-ordination pursued in earlier decades (although some disillusionment with international markets set in as the decade advanced and in the later-1980s there was renewed interest in international co-operation in the management of major-currency exchange rates).

In consequence, the machinery for international policy co-ordination - a role intended to be filled by the IMF - was marginalised. One aspect of this was the *de facto* refusal of major OECD governments to heed the advice of the IMF on policy co-ordination, already mentioned. Another was the emergence of a less favourable balance between financing and adjustment than existed in the preceding decades, imposing avoidable costs and adding further to the deflationary bias of the system. At the same time, the relevance of the General Agreement on Tariffs and Trade (GATT) was reduced as a result of the burgeoning of non-tariff trade barriers described below.

I.2 What might be done?

To go further into such questions as the desirability of greater international policy co-ordination and of the reform of international trading and monetary arrangements would take us too far afield. Evidently, getting rid of the asymmetries just described would help considerably in increasing the consistency of the global environment with economic adaptation by developing countries. But the inequality in bargaining strength which underlies the asymmetries is an intractable problem and there are no grounds at present for expecting any radical systemic reforms of international trade and financial arrangements. Probably the most that can be hoped for at present is agreement on more narrowly defined reforms. Which of the possibilities on the agenda might be particularly relevant to the concerns of this series of Working Papers?

Starting with trade policy, the essential task is to introduce policy changes which would (a) get rid of avoidable shocks and trends in the system, thus reducing the required scale of adjustment, and (b) promote developing country adjustment by improving their ability to increase export earnings. We can think of (a) as particularly relating to the condition of primary product markets and (b) as specially concerned with improving access of developing-country manufactured exports to industrial countries.

As regards the commodity markets, we have already suggested that there is little to be done about the underlying changes in the composition of demand. If we adopt the relatively long-term perspective taken in this series of Working Papers and accept Working Paper 31's suggestion that there is an underlying tendency for the real prices of primary products to decline, such devices as international commodity agreements and export compensation schemes are ill-designed to cope with this, being intended for reducing or cushioning the shock of short-term fluctuations. In principle, it might be possible to form producer cartels to raise prices by restricting supply, as OPEC did so successfully for a while. However, rather special conditions have to be satisfied if such arrangements are to be both practicable and beneficial to their members over the longer term. Despite its dramatic successes, even OPEC's supply management eventually proved unsustainable and it was unable to prevent real oil prices returning most of the way back to where they started in 1973. Supply management provides no solution to a long-run deteriorating trend in demand, although it can help in an emergency situation.

There are some things that could be done, however. One would be to reduce industrial-country protection of agriculture, described in Working Paper 34, which has a depressing effect on certain of the commodity markets on which developing countries are major sellers, notably sugar and cereals. Another would be to strengthen and liberalise existing compensation schemes to provide a more adequate buffer against short-term fluctuations in commodity prices and to give producing countries more time to adjust and diversify their exports.

The price signals coming from commodity markets have, however, been telling producing countries to reduce their dependence on primary products, to diversify their exports. It is important that this message does not get seriously diluted. A more suitable line of approach, therefore, is to work on the structure of industrial country protectionism, which normally increases as one moves up the production chain, with low protection on most unprocessed commodities which do not compete with local producers, more protection for semi-processed items, and yet higher barriers for fully processed goods. This structure of protection could almost have been designed to prevent export diversification by commodity exporting countries. In a sense, it was.

Another desirable change would be to reduce pressures on the producers which contribute to the chronic tendency to over-supply on most commodity markets. Many of them suffer from serious balance of payments difficulties, often associated with major debt burdens, so that measures by industrial/creditor countries to provide debt relief and balance of payments support would reduce the frantic scramble to expand the production of traditional exports.

A more specific suggestion along these lines relates to what has become known as 'the fallacy of composition'. This arises from the generally export-led nature of the adjustment programmes associated with the IMF and World Bank and concerns the aggregate effect on world commodity markets of measures designed at the single-country level. The countries in question are faced with acute payments difficulties. The quickest way of increasing their export earnings is likely to be through the expansion of their traditional exports, in which they already have a revealed comparative advantage. It will hence make apparently good sense to adopt such export-promotion policies and, in any case, there will often be no obvious alternative. But should a substantial number of countries supplying a given commodity all act in the same manner the net effect may be so to increase supplies and so depress prices as to give low, even negative, returns from the export policies. There is a kind of market failure here, with atomistic decision-making failing to result in a collectively optimal outcome.

To what extent this is a real problem is unclear, for it has been little researched. One study [Koester *et al.*, 1987], which however was confined to African producers, suggests that the position differs greatly among products. Of the six commodities studied, the fallacy argument seemed serious only for cocoa, with returns to additional investments in that crop likely to be negative. For the other five, the prospective returns from an

Africa-wide export expansion are shown to be positive in varying degrees. The effect of bringing other commodity-exporting regions into the analysis would, of course, be to increase the probabilities of immiserisation. The Bank's economists tend to respond to the fallacy argument by pointing out that Africa supplies a small part of world totals for most commodities, reducing the likely price-depressing effects of expansion. However, one cannot simply look at the African dimension; the argument has to be tested at the global level. There is need for more research here and, in the meantime, a *prima facie* case for a more systematic effort by the World Bank to safeguard against the danger that the programmes it supports will lead to self-defeating depression of commodity markets.

Turning to the question of <u>market access for developing-country manufactured exports</u>, the background to this is a serious increase in industrial country protectionism against this type of 'import penetration'. That there has been such an increase is widely acknowledged, although it is difficult to be precise because most of it has taken the form of a proliferation of 'non-tariff barriers' (NTBs) which are not readily amenable to quantification. It also seems highly likely that these NTBs have been applied in ways that discriminate against exports from developing countries. These chiefly affected manufactures. According to UNCTAD, in 1988 NTBs affected nearly 30% of all imports by Western industrial countries of manufactures from developing countries, against 17% of imports from each other.[5] Both proportions were higher than in 1981, although only marginally so in the case of NTBs against imports from developing countries.

Given the extent to which the newly-industrialising countries (NICs) have already stretched industrial-country tolerance of this type of import penetration and the resulting spread of protectionism, many are sceptical about the practicability for other developing countries of developing dynamic manufacturing export industries.[6] Against this scepticism, it has to be said that the protective barriers have not, in fact, proved very effective and have not prevented continuing rapid export expansion by the NICs. It is also easy to overlook that increased export earnings by developing countries adds to their spending on goods from the industrial world, thus reducing protectionist pressures, and that sales by developing countries still make up only a small proportion of total trade in manufactures. Finally, the small, low-income countries with which we are concerned are very small players in this game, so that it should be possible for them greatly to expand their manufactured exports without causing more than the smallest ripple in the ocean of world trade. Nonetheless, industrial country producers have proved very vigilant against the products of even tiny exporters, such as Mauritius, so smallness is no guarantee against the erection of protective barriers. At the time of writing the 'Uruguay Round' of trade negotiations under the GATT is under way. The outcome of this will be of crucial importance. In the meantime the obvious point should be restated: that there is a clear contradiction in the industrial world advocating

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5 See UNCTAD, 1988. The statistics quoted relate to manufactures other than chemicals. The (then) socialist countries were the most heavily discriminated against, however, with NTBs covering 40% of manufactured imports from them. For a useful general survey of trends in protection since 1974 see Page, 1987.

6 See Weiss, 1988, pp.300-06, for a balanced discussion of this question.

vigorous adjustment policies in developing countries while denying the access to their arkets necessary if the adjustment efforts are to succeed.

Turning now to financial flows, we have already seen in Working Paper 31 (Table 3 and the accompanying text) that the 1980s saw a decline in net capital flows to small low-income countries and we referred there to the difficulties created for them by the rise in world real interest rates - a rise which has continued. We must here particularly draw attention to the debt problems with which many of these countries are faced, indicators of which are set out in Table 1. The comparisons are between 1982, when the world first became conscious of the debt problem, and the latest year for which firm figures are available.

Table 1: **Debt Indicators for Indebted Low-income countries, 1982 and 1988**[a]
(values in $ bn. and ratios in percentages)

	1982	*1988*
Values		
Total outstanding debt	100.8	196.4
Total debt servicing payments	10.1	18.7
of which:		
Interest payments	5.3	7.6
Net transfers[b]	7.6	-0.2
Ratios		
Total debt/GNP	33.8	87.6
Total debt servicing/exports	18.1	32.1
Interest payments/exports	9.4	13.5
Interest payments/GNP	1.8	3.1

Notes: (a) An aggregation of data for low-income countries classified in World Bank, World Debt Tables, 1989-90, Vol. 1, as 'severely' and 'moderately' indebted. This therefore excludes a number of low-income countries which are not classified as indebted. See this source for definition of concepts used and country classifications.

(b) Excluding grants.

We see there that both the stock of total debt and the flow of total debt service payments nearly doubled over this short period, even though there were many debt reschedulings and a number of debt relief initiatives. We also see that the net flow of financial transfers (new loans minus total debt servicing payments) changed over this period from a net inflow of $7.6 billion to a small net outflow. The lower part of the table reveals that the deterioration was even worse when expressed in ratio terms, so that by 1988 total debt servicing absorbed a third of export earnings - a figure that would have been far worse had it not been for reschedulings and a build-up of arrears.

What is the relevance of this to the processes of structural adaptation? First, debt servicing obligations add to the foreign exchange constraint by claiming resources that otherwise could finance imports, with consequences already discussed in Working Paper 31.[7] Debt servicing obligations also absorb domestic saving that otherwise could be devoted to the types of investments that are necessitated by structural reorientation. By 1988 interest payments alone probably absorbed 20-25% of domestic saving in low-income countries.[8] Overall, the effects of the debt overhang have been to reduce the growth of output and exports by cutting back on import capacity, investment and the maintenance of the existing capital stock. It has introduced additional uncertainties into economic life, further discouraging investment and diverting the attention of policy-makers away from longer-term problems of adaptation. A vicious circle comes into play: import strangulation holds back export growth thus perpetuating import shortages. The uncertainties created by the debt situation and the nature of debt renegotiation processes further discourage investment which, in turn, holds back the restructuring necessary if economies are to 'grow out of debt'. Depressed export earnings, import volumes and economic activity reduce government revenues, increasing budget deficits and reducing government abilities to improve the balance of the economy.

The implication of this analysis, then, is that the debt overhang and the limited steps taken by creditor countries to provide debt relief in the 1980s are inconsistent with successful adjustment by those low-income countries that are heavily indebted. Although there were important moves to reduce the debt burden at the end of the decade, these were still inconsistent with the creditor governments' stated objective of permitting 'adjustment with growth' in the indebted countries.[9]

There was also evidence that adjustment programmes supported by the IMF and World Bank were being under-funded. This is illustrated in Box II, and the authors of the article upon which that is based argue along similar lines for Uganda, Malawi, Zaire and Mauritius. But why is aid necessary to support policy reforms? For the most part, the relevant policy changes absorb large amounts neither of foreign exchange nor of government revenues. Indeed, they are often intended to save or increase both

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7 For a discussion of the debt problems of sub-Saharan Africa, and their consequences, see Greene and Khan, 1990. Selowsky and van der Tak, 1986, provide an excellent analysis of the macroeconomic implications of debt servicing, even though they are chiefly concerned with more advanced Latin American-type debtor countries.

8 The World Bank's World Development Report, 1989, Table 9, estimates gross domestic saving for all low-income countries other than China and India at 15% of GDP in 1987, against the interest payments of 3.1% of GNP in 1988 shown in Table 1.

9 In 1988 ten major creditor countries agreed on a menu of options for providing greater debt relief to low-income sub-Saharan African countries than previous policies had permitted, under what became known as the Toronto agreement, but the total savings to the debtors were expected to be less than 1% of 1989 debt. For an account of this and other initiatives see ODI, 1990. A more substantial analysis of the African debt problem is provided by Mistry, 1988.

types of finance. Moreover, 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.

BOX II. THE UNDERFUNDING OF AN ADJUSTMENT PROGRAMME IN ZAMBIA [10]

During much of the 1970s and into the 1980s Zambia experienced a prolonged period of economic difficulty, occasioned partly by a severe deterioration in the terms of trade leading to major cuts in imports. In response, the Zambian government embarked on an intensive programme of policy reform in 1983, with the support of the IMF and World Bank. It established a foreign exchange auction which had the effect of introducing a massive devaluation of the country's currency, the kwacha; it liberalised interest rates and imports; acted to reduce inefficiency and financial haemorrhage in public enterprises; and reduced certain budgetary subsidies.

These reforms were associated with major credits from the IMF and World Bank. In addition the Bank made strenuous efforts to persuade bilateral aid donors to supplement these credits with additional allocations to Zambia. Despite this, bilateral aid commitments actually declined by nearly two-fifths during the reform period and this, combined with a decline in suppliers' credits, led to a decline in net financial resources flowing into Zambia by a similar proportion. Things were made worse by a further sharp worsening in the terms of trade, so that an already severely reduced level of imports had to be cut by a further 30%.

The programme broke down in 1987. This occurred for a number of reasons, not the least of which was a lack of unity within the government on the desirability of the reforms, but the decline in funding during a period when it was particularly needed must be included as a major factor.

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10 Based on Gulharti and Nallari, 1988, pp.1168-69.

In the light of the above discussion, the case for financial support can be made in terms of easing the period of transition, reducing the 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 change 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 that adds to import capacity - as contrasted with aid that is swallowed up by meeting debt servicing obligations - can thus play a key role in easing the transition. It can also add to confidence in the sustainability and success of the policies, reducing uncertainties and thus encouraging longer-term investments, foreign and domestic.

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 (see parts III and IV below), thus helping ministers to persevere with the policies without too greatly endangering their own survival. The under-funding and effects of the debt overhang described above can hence represent major obstacles to successful adjustment in some countries.

The thrust of all this is to urge upon the donor/creditor countries more generous, imaginative and flexible policies with respect to the provision of aid and debt relief, although to get into these subjects in any detail would take us too far from our main purpose. But such assistance brings with it a probably unwanted degree of donor/creditor influence on the design of domestic policies, conveyed by the vehicle of 'conditionality'. Such conditionality came to prominence during the 1980s and remains a major factor in the wider context with which this Working Paper is concerned. Indeed, it is probably not going too far to say that structural adjustment as it came to be understood and practised during the 1980s was essentially a product of the IMF and World Bank, particularly the latter. We therefore turn now to consider some of the issues arising from this.

II. ADAPTATION AND CONDITIONALITY

II.1 The spread and rationale of conditionality

Most credits from the IMF have long had policy strings attached but the movement of the World Bank into what it calls 'policy related lending' is a more recent development, with its introduction in 1979 of loans in support of structural adjustment programmes and its growing use subsequently of loans in support of sectoral adjustment programmes. This combined with the economic and financial difficulties in which many developing countries found themselves in the 1980s led to a very rapid spread in the influence of these two organisations (hereafter, the IFIs) over economic policy reform in developing countries. Thus, as at March 1990 the IMF had programmes in no less than 46 developing countries, with a special concentration in sub-Saharan Africa, where there were programmes in about two-thirds of member countries. Directly comparable figures are not available for the Bank but a measure of its involvement in policy change is provided by the statistic that in 1986-88 it made 38 structural adjustment or sectoral adjustment loans to low-income African countries alone, involving 70% of all such countries. The geographical coverage of IFI conditionality has thus become very extensive, so the effect that it has is a matter of considerable importance.

Although conditionality remains controversial and generates a good deal of resentment from time to time, it is hard to deny that those who provide financial assistance can legitimately take an active interest in the design of the recipient country's policies. If there is any general message that comes from this series of Working Papers it is that policies matter. The wisdom or otherwise of a government's economic policy decisions is liable to have a crucial influence on the subsequent performance of the country's economy. The importance of the overall policy environment, which we have seen as strongly influencing the effectiveness of policies for the exchange rate, agriculture, manufacturing and the financial sector, has been a recurring theme of the previous Working Papers in the series.

For such reasons, the policy environment is arguably the single most important determinant of the economic effectiveness of aid and debt relief which entitles aid/creditor representatives to a seat at the policy-making table.[11] In the absence of policy conditions, the danger is that financial assistance can be - and in some cases has been - used to defer needed action, to buy time in the hope that some favourable turn of events will remove the necessity for unpalatable action. Moreover, besides providing needed financial support, IFI involvement can help through the provision of advice, information and technical assistance in the preparation of adjustment measures. It can also provide the government with a useful scapegoat upon whom the blame for unpopular measures can be deflected.

At the end of Working Paper 31 we discussed the extent to which the IFIs view of adjustment coincided with the approach adopted in this series of Working Papers,

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11 For a survey of the literature on the developmental effectiveness of aid to Africa, which elaborates on this theme, see Killick, forthcoming, and the literature cited there.

concluding that their adjustment programmes could be thought of as an important subset of our own meaning of the concept, more confined in time and coverage but addressed to some of the most important problems of economic adaptation. Although there are serious problems, to be taken up shortly, the general thrust of the adjustment policies advocated by the IFIs is similar to, or at least consistent with, the policies advocated in this volume, so the IFIs are seen here as a force trying to change policies in usually sensible directions.

This consideration is reinforced by the absence of any intellectually persuasive and radically different approach to economic adjustment from that advocated by the IFIs, as distinct from 'reformist' suggestions for improving present approaches. It is true that a group of 'neo-structuralist' economists has been developing a major critique of orthodox approaches and has sought to develop a more thorough-going alternative. However, their efforts relate more to short-term stabilisation than to long-term adaptation; are more concerned with relatively advanced Latin American-type economies than with the small low-income countries which are our concern here; and, in any case, have not achieved general acceptance as offering a viable alternative model.[12]

Of greater potential relevance for our purposes is the work of the Economic Commission for Africa [ECA, 1989], seeking to develop an 'African Alternative Framework' for the design of adjustment programmes. It shares the premise that structural transformation is necessary but is highly critical of IFI approaches and therefore seeks to provide a different approach to the task. Unfortunately, they have so far only offered a conceptual framework within which country programmes might be designed and this leaves a rather large number of questions unanswered. Further, it appears to be predicated on major political changes within Africa, which leaves it uncertain how much would be left of their approach within existing political systems, and there is ambiguity about the importance it attaches to domestic and external balance as a necessary part of the adjustment process. In short, the ECA has not so far convinced many others about the coherence and practicability of its alternative.

Another line of approach is to look at the experiences of countries that have sought to develop their own heterodox approaches, of which Argentina (the Austral plan), Brazil (the Cruzado plan) and Peru might be cited as examples. Unfortunately, this offers little encouragement to those searching for an alternative to orthodoxy. While it is true that these programmes were undermined by the reluctance of creditor countries to provide finance in their support, each collapsed in some chaos and each has since been identified as having been seriously flawed. The experiences of African governments which have in the past sought to work out their own approaches are also discouraging: *e.g.* in Ethiopia, Tanzania and Zambia.

We conclude, in short, that IFI and other donor conditionality in structural adjustment programmes is legitimate, generally tries to move policies in a sensible direction and, in any case, that there is no convincing and thorough-going alternative approach

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12 See, for example, Taylor [1988] and the set of country studies linked to that volume. See also Kahler [1990] for an excellent survey of orthodoxy and its alternatives.

available. At the same time, however, there are major problems with the practice of conditionality and doubts about its effectiveness.

II.2 Does conditionality work?

Adjustment programmes suffer from the disadvantage that there are large methodological pitfalls in the way of any conclusive evaluation of effectiveness. How should we do it? Comparing results during the programme period with performance in preceding years is unsatisfactory because of the influence of changing world economic conditions and of the additional financial inflows that are triggered by the programme, because of numerous and varying time-lags between policy changes and their effects, and because we do not know what policies would have been in place in the absence of the programme. Comparing results with the targets set by the designers of the programme can similarly do no more than give us some pointers for the additional reasons that the targets themselves may have been unrealistic, or arbitrary, or designed to influence the results by influencing expectations. Another method that has sometimes been applied is to compare the results obtained for a group of countries pursuing adjustment programmes with a control group of non-programme countries. The central difficulty with this approach, of course, is to select a control group that is truly comparable.

The essential problem in programme assessment is that of the counterfactual: how can we judge what would have happened in the absence of the programme? There are other difficulties too: how to disentangle the effects of the programme from the effects of the increased availability of foreign exchange and capital provided by the credits which support IFI programmes, and how to handle different degrees of programme implementation across countries? There is also the quandary of deciding over what period the programmes should be assessed: do we look simply at results during the programme period, or at some longer period? It thus turns out that one of the limitations of adjustment packages is the difficulty of learning from experience.

Of course, we are not completely in the dark, for each of the approaches mentioned above does at least provide some pointers. Thus, most studies of the impact of IMF stand-by programmes tend to find that they improve the balance of payments. This result is confirmed by the most recent and sophisticated study to date, by Khan [1988], although the strength of the effect in Year 2 is considerably less than in Year 1, raising the question whether Fund programmes lead to sustained balance of payments improvement. Khan also confirms another finding of other researchers, that Fund stand-bys involve costs in the form of reduced economic growth, although here too the effect is weaker in the second year.

More relevant to our present purposes are the effects of World Bank structural adjustment programmes. The Bank has published two major recent evaluations. The most comprehensive of these [World Bank, 1989a] used the control group method without, unfortunately, employing much refinement to ensure true comparability. They were thus properly tentative in their conclusions. They found that, on average, programme countries had 'moderately' better economic performance than non-programme countries, in terms of economic growth and internal balance.[13] The differential in performance was greater for countries which had implemented a succession of programmes. However, they also found that adjustment was not being sustained in a number of countries, especially as regards the internal macroeconomic balance. They also found the differential results were weaker in Africa and in heavily-indebted countries, where the problems were greater. They also reported difficulties with programme implementation: three-quarters of all adjustment loans had had loan instalment releases delayed because of non-compliance with policy conditions, and about 40% of all conditions remained unimplemented at the end of the programme period.

Preliminary results obtained in independent research by Harrigan and Mosley [1989] have underlined the inconclusive nature of the Bank's results. Using a smaller sample of countries but a wider range of methodologies, they find that Bank programmes had no measurable effect on real GDP, positive effects on export growth and the balance of payments, and negative effects on investment levels. They also found a rather larger rate of non-implementation of programme policies than the Bank's 40%. Work by Faini and his associates similarly found no statistically significant programme impact on economic growth and lower investment ratios.[14]

Substantially stronger results are claimed in a second Bank evaluation, which is confined to experiences in sub-Saharan Africa [World Bank, 1989b]. This too uses a control group method, but simply on the basis of comparisons between countries with 'strong' reform programmes and countries with 'weak' or no reform programmes, with no other attempt to ensure comparability. The findings claim some tendency for faster GDP and agricultural growth in the strongly reforming countries; superior export and investment records; and a better record on the growth of private consumption. Savings performance, however, was better in the non-reforming group. The findings of this study are, however, difficult to reconcile with the Bank's other 1989 evaluation, just reported, and are subject to several of the methodological difficulties mentioned earlier, particularly as regards the choice of control group; the difficulty of differentiating between the effects of programme finance and programme policies; and the absence of testings for statistical significance in the results obtained. It also contains a larger-than-usual degree of subjectivism.

One way of trying to overcome some of the methodological difficulties is to undertake in-depth country studies, although it is dangerous to generalise from them. A study by Bank staff [Nooter and Stacy, 1990] uses this approach by studying adjustment

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13 Just how moderately better can be judged from the following results, which show the percentage of performance indicators which improved during the period of the programme:

Programme countries	54
Countries with 3+ adjustment loans	63
Control group (non-programme countries)	46

14 See Faini *et al.*, 1989 and forthcoming. However, the validity of their results in the latter study is contested by Peter Montiel in Thomas *et al.* [forthcoming], who suggests they may be the consequence of sampling errors.

programmes supported by the Bank in seven African countries but this too yields only weak results (p.14):

> *Only three of the seven countries under review (Ghana, Guinea and Madagascar) appear to have adopted adjustment programmes which are broad and deep enough to constitute effective, growth oriented adjustment programs. Even in these cases, further adjustment measures will be necessary. Since the seven countries under review are considered by the Africa Region [of the Bank] to have the most effective programs in the region, it can be assumed that the adjustment programs not reviewed are also not yet fully comprehensive (with the exceptions of Gambia and Mauritius . . .)*

To sum up, we cannot provide strong evidence that IFI-supported adjustment programmes achieve their objectives. The indications are that, when implemented, they help in some degree but that the results are less than dramatic and are particularly inconclusive for Africa. Indeed, there is a distinct shortage of countries of which it can be convincingly claimed that adjustment programmes have made a decisive difference, particularly in Africa and Latin America, although in some there has been encouraging progress. Moreover, the question of the sustainability of the reforms - their ability to produce consistently better results over a period of years - is particularly critical, and there is an even smaller number of countries of which it can be said that improvements have become self-sustaining.

Given this rather indecisive evidence on whether adjustment works, the question arises, if not why not?

II.3 Sources of weakness

The answers to this question can be roughly divided into three types: difficulties created by a hostile global environment; more-or-less technical considerations relating to the design of economic policy packages; and matters relating to relationships between aid agencies and recipient governments. The first of these was dealt with in Part I above; the other two require some elaboration.

□ Technical considerations

It is clear from the earlier Working Papers in this series that the design of policy packages to foster economic adaptation is no simple matter. We have drawn attention to the centrality of trade-offs in policy-making and the difficult choices they can pose. We have stressed the importance of viewing economic policies as a system, the complex interactions that occur between policy and target variables (including time lags between policy decisions and their effects), and how indirect effects can be quite different from the direct impact of a policy change. We have drawn attention to the necessity of considering carefully the desirable sequence in which various actions should be taken. We have urged the sensitivity of results to particular economic structures, the need to tailor-make policies to the specific circumstances of the problem in hand, and the dangers, therefore, of applying generalised solutions. And at various points we have had to draw attention to deficiencies in our knowledge of how things work and how they might be improved.

The construction of adjustment programmes, in other words, is a difficult, complex business. This is true generally, not just of IFI-supported programmes. However, it does raise questions about the effectiveness of conditionality, for donor agencies will often not have enough experienced personnel with intimate knowledge of local circumstances to be able to design policy conditions, or provide advice, which is appropriate for local circumstances (not the least because the Bank and Fund have for some years been under pressure to keep down their staff numbers, with the result that many of their professionals have become seriously over-extended). An almost inevitable result, reinforced by a desire to achieve comparability of treatment across countries, is to resort to a more-or-less standard approach. This has long been a complaint about the conditionality of the IMF, which faces particular constraints in varying the content of its programmes across countries, and there is evidence that Bank programmes are more tailored to country circumstances.[15] Even with the Bank, however, there are limits to its degree of flexibility and there are institutional pressures for the use of standard recipes. In other words, the inherent limitations on the expertise and freedom of action of the IFIs makes it difficult for them to cope with the complexities and uncertainties of devising adjustment packages. To put it another way, home-produced programmes probably stand a better chance of coping with the complexities than programmes largely initiated from outside.

Another area of difficulty relates to the reconciliation of the demand-management approach of IMF stabilisation programmes and the supply-oriented thrust of Bank structural adjustment programmes. Earlier Working Papers have already hinted at some of the difficulties. Thus, Working Paper 31 refers to the danger that IMF-type programmes which envisage large reductions in imports are liable to erode export supply responses, to say nothing of the costs imposed by way of output foregone. At a more microeconomic level, Working Paper 34 mentioned the dangers of counter-productive cuts in agricultural services as a result of the reductions in government spending often incorporated in IMF programmes.

To put the case in more general terms, tensions can arise between demand-management and supply-oriented programmes as a result of differences in the requirements for programme success in respect of (a) import levels, (b) volumes and terms of domestic credit and (c) government expenditures on economic services and/or capital formation. In principle, there is no inevitable contradiction in these requirements. They can be reconciled, depending on: the amount of external finance available in support of the programmes and, therefore, the period of time over which macroeconomic balance must be achieved; the respective priorities placed upon the short-term stabilisation and longer-term adjustment objectives; and the range of effective policy instruments available to the government. The first - finance and time - is likely to be a crucial determinant. In the world described in Part I above, in

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[15] In an unpublished study of a number of Bank structural adjustment programmes in Africa William Kingsmill found considerable variation in the content of these programmes, including different approaches to similar problems in different countries, although the broad thrust of the programmes was the same. On IMF conditionality see Killick *et al.*, 1984, especially pp.199-205 on programme flexibility.

which supporting finance is distinctly scarce, it has happened all too often that longer-term adjustment has had to be sacrificed to short-term stabilisation.

An implication of this is that the two IFIs may sometimes give differing advice to governments or, in the worst case, may lay down conflicting conditions, although the latter is usually avoided. The dilemmas created for governments become even more acute when it is seeking to execute simultaneously Fund and Bank programmes and when these are subject to cross-conditionality. By this is meant situations in which access to the credits of either IFI depends upon observing the policy conditions of both. In practice, this generally takes the form of requirements that a government must first agree a stand-by (or similar) programme with the Fund before the Bank will agree to a structural adjustment credit.[16] One of the problems with such cross-conditionality is that it assumes away the tensions between stabilisation and structural change. Indeed, it requires that there be no incompatibility. Unfortunately, it is a requirement that is not always met, as is illustrated for Jamaica in Box III. Although quite vigorous attempts have been made to strengthen Bank-Fund co-operation in recent years, in practice there remains a good deal of disagreement between them, particularly at the country level.

We should also recall the so-called 'fallacy of composition' problem discussed on pp. 5-6 above. Essentially, this draws attention to difficulties of ensuring that the aggregated results of individual country programme targets for export expansion are consistent with overall world trading conditions, and the dangers inherent in putting one programme together largely in isolation from programmes in place or in preparation elsewhere.

□ **Donor-recipient relations**

The suggestion that can be made here is that the very fact of conditionality, and the nature of the donor-recipient relationship which it implies, tends to undermine programme effectiveness.[17] Much hinges on the extent to which there is genuine agreement between the IFIs and the government in questions about the desirability of the programme and its specific provisions. Where there is a real meeting of minds conditionality is really not necessary (except of a *pro forma* kind to comply with Board requirements in Washington) because the governments would have undertaken the policy changes anyway. But if we think of conditionality as defining those actions that would not have been undertaken by the government except at the insistence of an IFI or other donor agency then it becomes close to tautological to say that the government is not fully persuaded of the desirability of the changes.

One source of difficulty here may be a mis-match of values or of objectives. There is a direct lineage between much of the thrust of the orthodox adjustment programmes of the 1980s and the 'conservative revolution' which occurred in the politics of North America and much of Europe in that decade, particularly the emphasis they gave to reducing state interventions in the economy and greater reliance on market forces.

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[16] On this subject see Commonwealth Secretariat, 1986, and Griffith Jones, 1988.

[17] For a trenchant statement of such a viewpoint see the note by Elliot Berg in Thomas *et al.* [forthcoming].

BOX III. STABILISATION VERSUS ADJUSTMENT IN JAMAICA, 1984-85 [18]

During 1984-85, Jamaica attempted to implement both an IMF standby agreement and a World Bank Structural Adjustment Loan. The former concentrated on demand-restraining conditions, while the latter focused on increasing supply. However, despite a considerable degree of coordination between Fund and Bank in preparing the programmes, the policies used to comply with the IMF targets largely undermined the supply-oriented growth aims of the Bank.

This was particularly true of tight monetary policy, including nominal interest rates above 25%. This was intended to restrict the amount of domestic currency available for firms to borrow and use to bid in the foreign exchange auction, and to induce foreign private capital inflows. Both measures were expected to reduce downward pressure on the exchange rate and ease the foreign exchange constraint on growth.

However, such policies put much of the burden of stabilisation onto the private sector. In the context of imperfect financial markets and economic uncertainty foreign capital did not appear, and pent-up, repressed demand for foreign exchange and psychological factors depreciated the exchange rate rapidly. Although rapid inflation made real interest rates negative, high nominal borrowing rates adversely affected private sector investment levels because investors saw their expected profits slashed. Commercial bank loans to companies fell sharply, and many firms developed liquidity and cash-flow problems due to rising burdens of past debt and inability to borrow for working capital. This was partly because the debt-equity structure of many firms was heavily weighted towards debt, reflecting incentives designed to increase supply implemented under previous World Bank loans. This resulted in an increased bankruptcy rate, especially for smaller firms.

In addition, growing uncertainty about the level of the currency and the high cost of borrowing funds for the exchange auction led many exporters to experience shortages of imported equipment and inputs. Several tried to reorient production away from exports to the domestic market. At the same time, devaluation failed to cut import levels: the current account deficit was twice as large as the IMF target. These adverse effects on investment and the balance of payments fed through into output performance and were one principal cause of a fall in GDP, by 5% during 1984-85.

It was not essential to follow a high-interest policy. Larger budget expenditure cuts or more devaluation could have been implemented instead, although capital and welfare expenditures were already acknowledged by both Fund and Bank to be grossly underfunded. Nevertheless, the methods chosen to implement their programme produced a conflict between stabilisation and adjustment.

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[18] This box is based on Harrigan, 1989, pp. 26-33.

However, this shift in the political centre of gravity affected only some Third World countries, and in some cases conditionality embodied policy changes that were in conflict with the philosophies of the governments in question.

A closely related point concerns the possibility of conflicts between the objectives of the IFIs and those of the government, even when broadly the same philosophy is shared. The IFIs have to satisfy their major shareholders, who often take a lively interest in what loans are made to whom and for what, and who sometimes seek to use their influence on the IFI Boards to promote the foreign policy and/or commercial interests of their own governments. The IFIs see their loans to any one country in the context of a far larger set of lending activities, so that decisions about policy changes in one country will be influenced by what is being done elsewhere. Indeed, in the context of the 'fallacy of composition' above we have urged that this should be so. The lending decisions of the World Bank, as well as the regional development banks, will also be influenced by the need to maintain their credit rating on world capital markets, on which they raise much of their capital. Moreover, large bureaucracies generate their own internal politics and these too will influence the content of conditionality. Thus, the Bank has long acknowledged that some of its earlier structural adjustment loans specified far too many policy changes but its internal politics have prevented it from remedying this defect as much as its management would like.

Governments and those who comprise them, on the other hand, are supposed to concentrate on promoting the national interest. Additionally or alternatively, they may have other worries: how to win (or avoid!) an election, how to keep the army happy, how to reward supporters and deal with the opposition. In short, government and IFI objectives may not match up and this may lead to disagreements about policies. There may also be disagreements of a more intellectual nature as Elliot Berg has pointed out:[19]

> *Many of the intellectual or analytical underpinnings of 1980s-style adjustment lending are contested - such fundamentals as the feasibility of export-led growth, the efficacy and beneficence of deregulated markets, and the desirability of market-determined interest rates or exchange rates. It is true . . . that there is more consensus on these ideas now than there was ten years ago. But . . . profound disagreements remain. Similar disagreements remain on less cosmic matters, such as the size and timing of exchange rate adjustments, the desirability of border pricing for basic foods, and the degree and the speed of reducing industrial sector protection. Since consensus is lacking in many countries on important loan conditions, implementation will tend to lack conviction and programs will be easily diluted or derailed.*

He goes on to point out a further source of resistance:

> *Political and bureaucratic consensus is even more uncommon . . . Agreements negotiated and signed by ministers of finance or planning are implemented by sectoral ministries. Sometimes these ministries are only perfunctorily consulted; often they are in deep disagreement with the spirit and particulars of the reform program.*

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19 The following quotes are from p.4 of a draft of Berg [forthcoming].

He points out a further source of difficulty, that conditionality gives the impression that programmes are being imposed upon a reluctant government even when they are not. This public perception will tend to undermine the legitimacy of the programme and the likelihood, therefore, that it will be successfully implemented and sustained. Even where that does not occur, extensive IFI determination of the content of a programme will weaken what the Bank calls the government's sense of 'ownership' of the programme, which may well be the most important determinant of programme success. Although the IFIs are well aware of the danger, the modalities of programme negotiation are not always such as to maximise the government's identification with it.

Such circumstances are liable to throw up programmes which governments do not regard as their own and of which, therefore, they will implement only the inescapable minimum. Consequently, some governments have become adept at finding ways that do not formally contravene the agreed policy conditions but which effectively restore the *status quo ante*. One of the difficulties is that, by insisting on major policy changes, the IFIs *ipso facto* become important players on the domestic political stage but without the ability to assemble a coalition of interests sufficient to sustain the reforms, particularly if the economic situation improves and economic pressures diminish. Moreover, their prescriptions may sometimes threaten the survival or unity of the government, and/or clash with the collective or personal interests of the bureaucracy. In such situations, it is the domestic actors who are likely to prevail. Technocratic solutions have their limitations, particularly when originated abroad.

This draws attention to a related feature: that IFI-supported adjustment programmes are often associated with economic crisis.[20] Crises are often necessary before radical policy decisions can be taken. But this raises the risk that the decisions will be hastily arrived at, on the basis of poor information and with inadequate consideration of administrative aspects. The chances of implementation are poor in such circumstances. Those policy changes most likely to be carried through successfully are probably those that emerge organically and gradually through existing domestic political and bureaucratic structures. Conditionality-related reforms are unlikely to have these qualities and are thus bound to be fragile, undermined by their crisis-driven nature. It may well be that this type of consideration would help to explain the relatively successful adjustment experiences of various Asian countries. As a generalisation, it seems probable that their past adjustment policies have been more home-grown, less crisis-ridden, less donor-driven, and that this has contributed to programme success. If this is so, it reinforces the importance of the 'ownership' factor in adjustment policies and cautions against excessive expectations about what conditionality can achieve.

There is also a substantial element of bluff in IFI conditionality which further undermines the process. There is a good deal of signing of apparently tough policy agreements in the execution of which, however, the government knows it will be allowed much latitude. Fund and Bank missions are often under pressure not to return to Washington without an agreement. Both institutions are making new loans

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[20] In this and the previous paragraph I am heavily influenced by a paper by Grindle and Thomas [1989] and by the proceedings of a 1988 conference on the politics of policy reform organised by the Harvard Institute of International Development.

in order to protect the repayment of past credits, or to avoid the borrowing countries from moving into arrears with them, or to validate an already negotiated debt rescheduling agreement. Both come under considerable political pressures from major shareholders in favour of particular countries. Moreover, once the process has commenced, the IFIs can get locked into a country: their commitment to making a success of the programmes they have financed pushes them into providing yet more finance so that the threat of withdrawal of funds because of non-compliance with a policy condition loses a good deal of its plausibility. As a result, IFI conditionality can in some countries be little more than a paper tiger.

Finally, we should note the limitations inherent in the relatively short time spans of IFI programmes. The emphasis in this series of Working Papers has been on structural adaptation as a continuous process, as something inseparable from the very process of economic development. It has brought out the considerable time lags that are often involved; the benefits of a steady, persistent adherence to policies that maintain balance in the economy and help it to adapt to changing circumstances; and the potentially heavy costs of a shorter-term and therefore more draconian approach to adaptation. The staffs of the IFIs are, of course, aware of these things and would agree with them. Indeed, the chief lessons from this are for developing country governments. But the fact is that there are institutional and political imperatives acting upon them (and in the case of the IMF, constitutional limitations on the term of their lending) which in practice make it difficult for the IFIs to take such a long-term view. The relatively short-term nature of their programmes itself diminishes their effectiveness, even after allowing the possibility of a succession of programmes in a country.

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To sum up, IFI conditionality is closely associated with the structural adjustment movement which gained so much momentum in the 1980s. As such, it is part of the wider context with which this Working Paper is concerned. We have shown that there are good reasons why the IFIs, and their major shareholders, should take an active interest, for the policy environment is probably that most important single determinant of the economic effectiveness of financial assistance. We have also suggested that IFI advice on adjustment policies generally pushes in a sensible direction. However, we have suggested that there is little evidence that IFI conditionality is markedly effective in practice and have suggested both technical and other reasons for this. Conditionality probably has most effect when IFI intervention is enough to tip the domestic policy-making balance in favour of reform, but that will be a rather rare conjuncture. In other circumstances it risks being rather impotent and at worst can actually get in the way.
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III. ADAPTATION, POVERTY AND THE ENVIRONMENT

III.1 Adjustment costs

We turn now to issues nearer to home. When pointing out the frequency with which policy-makers have to confront trade-offs between competing objectives Working Paper 32 signalled the existence of adjustment costs, against which the benefits had to be set. In fact, the literature abounds with references to the costs of the adjustment policies of the IFIs but discussions of these costs are rather loosely formulated so it is worth spending a little time to elucidate this.[21] Various types of cost 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 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. Such cuts can be seen as costs, resulting in lower consumption 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.[22]

In institutional terms, absorption costs arise more commonly in connection with the stabilisation programmes of the IMF, which is one of the reasons why controversy often 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.

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

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[21] See, however, Corden, 1989, and Huang and Nicholas, 1987.

[22] 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.

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 a hotel worker; even within agriculture land in a given ecological zone is not necessarily suitable for conversion from cultivation of one crop to another. The concluding pages of Working Paper 34 are taken up with this type of issue, applied to the difficulties of the transition from a high-cost to an internationally efficient manufacturing sector.

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 closely related category of particular relevance to our present concerns 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 affects the relative sizes of sectors of production and these employ differing factor proportions. Structural change thus gives rise to differing groups of gainers and losers, whose short-term interests can be in conflict with one another.

Net 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 avoided 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 31, poor countries have inflexible economies. This means that frictional costs are likely to be particularly severe. Starting from already very low 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.

III.2 Dangers to the poor

An important proposition to emerge from Working Paper 31 was that a well functioning market system is conducive to economic flexibility. It can handle large volumes of information in a decentralised way and convert it into appropriate incentive signals. And competitive forces can raise supply elasticities and hence the responsiveness of an economy to changing relative prices. This is a theme which has been further developed in subsequent Working Papers and although we have argued for a large and active role for the state, we have seen it as acting more through market signals, or as being directed to allowing markets to work better.

At the same time, Working Paper 32 identified as a common market failure the existence of degrees of poverty and income inequality inconsistent with what society regards as equitable. In this case, greater reliance on markets to achieve structural adaptation could be associated with increases in inequalities which further impoverish the poor. A question which emerges as of special importance is, how are the costs of adjustment to be distributed across society and how can we protect those already below the poverty line?

An answer to this, however, presumes that we know who the poor are, their characteristics and how they fit into to the economy - a presumption that is often unjustified. Such information is essential because the poor are far from being an homogenous group and how adjustment policies affect - and can protect - them depends crucially upon the nature of their sources of income. One fairly well established generalisation is that many of the short-to-medium-term adjustment costs tend to be born by the urban population but in most low-income countries a large majority of the poor live in rural communities. This is illustrated for selected countries in Table 2, where we see that typically 80-90% of those classified as living in poverty are in rural areas.

The urban poor may be particularly at risk from adjustment policies, however, as a result of public sector job retrenchments, other frictional unemployment, and possible loss of food subsidies and other welfare provisions. Among the rural poor much will depend on: their access to land; whether those with land are producing cash crops (likely to benefit from higher producer prices) or local foods (whose relative prices are less likely to go up as a result of adjustment policies), and whether they are net sellers or buyers of food; and the extent to which they are integrated into the modern market economy. There is much evidence that households headed by women are particularly at risk because they have often had fewer educational opportunities, are confined by cultural *mores* and active discrimination to less lucrative work, sometimes face legal or customary restraints on the ownership and inheritance of wealth, and are discriminated against in the provision of government services.[23]

Table 2: Rural and Urban Poverty in Low-Income Countries in the 1980s

Country	*Rural population (percentage of total)* (1)	*Rural poor (percentage of total)* (2)	*Infant mortality (per thousand)* *Rural* (3)	*Urban* (4)	*Access to safe water (percentage of population)* *Rural* (5)	*Urban* (6)
Côte d'Ivoire	57	86	121	70	10	30
Ghana	65	80	87	67	39	72
India	77	79	105	57	47	80
Indonesia	73	91	74	57	36	46
Kenya	80	96	59	57	21	61

Source: From World Bank, 1990, Table 2.2.

The heterogenous nature of the poor and the varying ways in which they fit into the overall economy make it impossible to generalise about the impact of IFI-type adjustment programmes upon them. Typically, some of the poor will lose, some will gain.[24] Significantly, the organisation that has done most to urge the need to protect the poor in adjustment programmes, UNICEF, is quite cautious about blaming such programmes for worsening poverty, although it does regard them as having been a contributory element.[25] It has pointed out, however, that few of the programmes of the 1980s incorporated specific provisions to safeguard the position of the poor, who thus stood to suffer as a result of heedless neglect.

[23] Lewis (ed.), 1988, provides a valuable assessment of the lessons of experience in identifying and assisting the poor. See the article in his volume by Mayra Buvinic and Margaret A. Lycette on 'women, poverty and development'.

[24] Thomas and Weidemann [1988, p.69] cite the policy reforms in Zambia in 1983-87, which reversed the previous heavy taxation of agriculture and shifted relative prices in favour of the rural economy, as an example of an adjustment programme beneficial to the poorer segments of the population.

[25] See Cornia *et al.*, 1987, for a general statement of the UNICEF view (especially p.288), and Cornia *et al.*, 1988, for a set of ten country case studies.

As already suggested, one danger particularly affecting the urban poor is that of job losses, resulting from the recessionary effects of reductions in absorption, or from job cut-backs in the public sector, or from the decline of certain industries following shifts in relative prices. Another danger arises from the cut-backs in government spending which are often associated with attempts to reduce absorption and budget deficits. It is often argued that when faced with the need to cut governments tend to give low priority to social and economic services, in favour of military and administrative expenditures.[26] This indeed is what has happened in a number of the heavily indebted countries of Latin America but the same trend is less evident for low-income countries. Thus the World Bank [1990, Table 7.5] found that in Africa when governments had to prune their budgets social spending was cut less than other categories (although there were nonetheless large real reductions in social spending) and this was consistent with earlier evidence.[27]

This is less than fully reassuring, however. For one thing, much of the burden of cuts falls upon the economic services provided by the state and its investment in the economy's infrastructure - and the poor are liable to lose from these reductions. Second, there may be a particular tendency to cut back on food subsidies, for these often place severe burdens on the budget.[28] While general food subsidies are an inefficient way of helping the poor, because many of the benefits are enjoyed by those who could afford to pay market prices and the effect may be to depress the price paid to farmers who themselves may be poor, some of the poor do nonetheless gain, particularly in the towns, and can be badly affected by subsidy cuts.

There is also a serious danger that the quality of social services will be reduced during times of budgetary stringency, even when the share of social spending is protected. The thing that governments find hardest to axe is jobs. There is hence a strong tendency to avoid reducing the civil service by instead pruning the supporting expenditures that make civil servants productive: drugs for clinics, books for schools, transport for social workers.[29]

The poor may also lose from any slow-down in economic growth which results from adjustment efforts. The position of the poor is, in the broadest terms, determined by the overall level of income achieved in an economy and by the way it is distributed.

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26 The UNDP, 1990 (pp. 76-78), particularly draws attention to the expansion of military spending in low-income countries. This grew at 7.5% *p.a.* in real terms in the least developed countries in 1960-86, much faster than total GNP, so that it increased its share of GNP from 2.1 to 3.8% and, of course, much larger proportions of total government spending.

27 Hicks and Kubisch, 1984, found social expenditures to be cut the least in times of overall government expenditure reductions, particularly in low-income countries. However, expenditures on economic services and, especially, on infrastructure suffered disproportionate reductions.

28 Zambia provides a case in point. In 1986 subsidies on maize meal alone accounted for 16% of the government's total budget deficit but attempts by the government to cut back on these caused riots and led to the abandonment of an adjustment programme supported by the IFIs (*c.f.* Thomas and Weidemann, 1988).

29 Cameroon provides an extreme example of this, where the share of salaries in total government recurrent spending rose to 99% during a fiscal crunch in 1985-87 (World Bank, 1990, p.117).

In the presence of large inequalities, there can still be many people living in severe poverty even in countries with relatively high average incomes; with a more even distribution widespread poverty can be avoided even with moderate *per capita* incomes - features which are illustrated in Table 3. The position of the poor can hence be improved by increasing incomes in general, by redistributing income in favour of the poor or some combination of the two.

Table 3: GNP per capita and Selected Social Indicators

Country	*GNP per capita (US$)*	*Life expectancy (years)*	*Adult literacy (%)*	*Infant mortality (per 1,000 live births)*
Modest GNP *per capita* with high human development:				
Sri Lanka	400	71	87	32
Jamaica	940	74	82	18
Costa Rica	1,610	75	93	18
High GNP *per capita* with modest human development:				
Brazil	2,020	65	78	62
Oman	5,810	57	30	40
Saudi Arabia	6,200	64	55	70

Source: UNDP, 1990, Table 1.1.

In the long run, however, and in countries starting from low average incomes, it becomes impossible to continue to improve the position of the poor without overall economic growth, because there are severe limits upon the extent to which the state can redistribute income and wealth without running into evasive action on the part of the relatively well-to-do and without eroding incentives to save and invest. Similarly with the costs of adjustment: these are likely to be smaller and better tolerated when the overall economy is growing than in conditions of stagnation. Thus, in the face of changes in the structure of production, it makes a great deal of difference to employment prospects if a shift from one industry to another is absolute - involving the actual decline of the disfavoured industry - or merely relative, meaning that it will grow more slowly than the favoured industry. The danger of adverse budgetary cuts will also be less if it is possible to maintain a reasonable pace of economic growth, for growth, in turn, will impart greater buoyancy to government revenues and reduce budgetary pressures.

So, while growth is far from being a sufficient condition for the long-run alleviation of poverty, in low-income countries it is certainly a necessary condition. Hence, any economic slow-down makes it harder to protect the poor.

Adjustment, then, endangers the poor in a number of ways: from job losses, reduced subsidies and social and economic services, and the adverse effects of economic slow-down. This danger is made all the greater by political considerations. The politics of adjustment is the subject of Part IV so we can confine ourselves here to pointing out the frequent tension between the distribution of political power and a desire to provide special protection to those living in poverty. For the poor are usually unorganised, rarely powerful. It is the relatively well-to-do who command political clout and it is their opposition that the government will desire to buy off or to manage in some other way. The politics of compensating those who lose from adjustment rarely favours the poor, which places them even more at risk.

It would, however, be quite wrong to view structural adjustment as a zero-sum game, in which gains are necessarily offset by 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 - but in the meantime we need to protect the most vulnerable.

We should similarly not overlook the risks to the poor of postponing adjustment, or of resisting the adaptation of the economy. In the face of imbalances governments have often tried to repress the problems by using import and price controls, heavy implicit taxation of agriculture, and an undiscriminating protection of industry. Such defensive responses have often been associated with the emergence of large scarcity rents (and corruption) and capital flight which distort the distribution of income to the advantage of a favoured few, erosion of real agricultural incomes and of the government's own tax base, and a general economic slow-down. All these developments are likely to be bad news for the poor. Protection of the vulnerable requires <u>orderly</u> adjustment, which incorporates poverty-alleviation measures, and is most unlikely to be achieved when adjustment is forced upon a reluctant government by the brute force of events.

But what specifically might be included in adjustment policies in order to safeguard the position of those living in poverty?

III.3 <u>Protecting the poor</u>

All governments, in whatever kind of society, find it difficult to reach the poorest effectively. They exist on the margins of the economy, they are unorganised and poorly educated, they are often suspicious of the state and its officials, and there is often much ignorance about them. Protecting the poor from the costs of adjustment is, therefore, an inevitably difficult task, even when the intention is strong. Only efforts based upon careful planning and determined implementation are likely to bring good returns. Often a necessary starting point is to find out more about the economic and social characteristics of the vulnerable and how they fit into the economy. Only when it is possible to identify the target groups, and how different policy instruments affect them, are we likely to be able to provide much assistance - and to safeguard against the danger that many benefits intended for the poor actually get captured by the not-so-poor. Sometimes a major research effort will be needed to gather and analyse the necessary information.[30]

Assuming the necessary knowledge base exists, we can then identify five broad approaches to helping the poor in adjustment programmes:[31]

- increasing their access to productive assets, *e.g.* land;
- raising the returns they can achieve from the productive assets they already possess, *e.g.* by the provision of extension advice;
- improving their employment opportunities;
- improving their access to education and health services;
- supplementing their resources with transfers, *e.g.* through food subsidies.

Various levels of policy can be brought into play in executing such a package. Macroeconomic policy can be given a greater orientation toward maintaining economic growth than is often the case, especially with shorter-term stabilisation efforts. There is also a role for what have been called 'meso'-level measures [Cornia *et al.*, 1987, p.291], *i.e.* policies which mediate between macro measures and the poor. These, for example, would safeguard the position of the social services during periods of budgetary stringency. Sectoral policies can be used, *e.g.* to safeguard against inappropriately capital-intensive production methods and to create employment, or to provide special help to smallholder farmers and those operating in the economy's informal sector. At a more microeconomic level, policies within sectors can be changed to help the poor, *e.g.* to ensure that they are not discriminated against in the provision of public education and health services, or to target special public works or nutritional programmes on the poor.

Following UNICEF, certain additional broad principles can be added. One is that measures to protect the poor are much more likely to be effective if they are built into the original design of an adjustment programme than if they are treated separately or added as an afterthought. This is among the lessons to be derived from the highly-successful South Korean experience, sketched in Box IV. Another is that raising the productivities and incomes of the poor is central to any strategy for improving their material well-being, for we have already suggested that there are rather severe limits to governments' abilities to redistribute existing income in favour of the poor and, in any case, productivity-raising measures lessen the danger that the poor will become

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30 Calls for more research as a preliminary to further action can, of course, be used as a device for postponing substantive action indefinitely. On the other hand, when basic information simply does not exist it is difficult to see how an effective package of measures to protect the poor can be put in place, although there may well be some things that can be done right away. Glewwe and van der Gaag [1990] have shown how the size and composition of 'the poor' can vary greatly according to the definition employed.

31 The following is based closely on Demery and Addison, 1987.

dependent on special help. One aspect of this task is to try to find ways of increasing the participation of the poor in sectors of production which can be expected to grow in the process of structural adaptation.

BOX IV. PROTECTING THE POOR FROM ADJUSTMENT COSTS IN SOUTH KOREA [32]

In consequence of a mixture of adverse international and domestic developments, the previously fast-growing economy of South Korea went into a recession in 1979-80, causing average incomes to decline by a tenth and even larger regressions among the poor. Their diets worsened and social progress was threatened in a number of ways.

The government responded in 1980 with a stabilisation-adjustment package which sought to stabilise prices, liberalise trade and the economy and encourage structural change towards technology-intensive industries. At the same time it incorporated measures to safeguard the poor. These included a medical assistance programme targeted at the lowest income groups; public works programmes to provide work for the poor during the crisis; a programme of transfers also targeted on the poor, including provision of food, assistance for fuel and increased educational subsidies; and increased public spending on education and low-cost housing.

The package was broadly successful both in its overall economic objectives and in protecting the poor. Indeed, the percentage of absolutely poor and the infant mortality rate continued to decline at historical rates despite the recession and restructuring. Success at the macro level in restoring economic growth itself helped to improve the position of the poor.

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32 Based on chapter 8 of Cornia *et al.* [1988] by Sang-Mok Suh and David Williamson.

A further principle is that, for such in-building to occur, a wider range of government departments and other agencies (including non-government organisations - NGOs) will need to be involved in programme design than the usual concentration upon the Ministries of Finance and Planning, although problems of co-ordination multiply rapidly as more are brought in. Another lesson of experience is that attempts to protect the poor are more likely to be successful if the pace of adjustment can be fairly gradual, for we have earlier suggested that adjustment costs are a rising function of the speed of change. This plea for a more gradual approach underlies the case for more growth-oriented programmes, for growth is almost certain to suffer with 'sharp shock' approaches. But for more gradual adjustment to be feasible, more external financial support will be necessary to finance the intervening period before a viable macroeconomic balance is restored, and that takes us back to the whole question of access to world savings discussed in Part I. A final general principle is that programmes should incorporate mechanisms for monitoring their impact on the poor and the effectiveness of the safeguards designed to protect them.

We turn now to take up a few more specific policy possibilities. Since most of the poor live in rural areas one obvious possibility is to use agricultural policies for poverty-alleviation. Uma Lele has put the case trenchantly:[33]

> *In Africa, growth in agricultural production is essential for poverty alleviation; technical change in agriculture is essential for growth; appropriate balance in the availability and deployment of physical, human and institutional capital is essential for technical change to occur; and it is the lack of such balance in the accumulation and use of different forms of capital that explains the persistence of poverty.*

Such policies would need to be focused on the needs of smallholder farmers and the landless and, depending on country circumstances, could include land reforms that would redistribute land from large estates to those with little or none; policies to discourage labour-replacing technologies and to favour employment creation; improved producer prices; and improved provision of research, extension, marketing and other public support services to our target groups, including greater attention to the problems of those farming land which is marginal or with an unreliable climate.

At the same time, we need to be conscious of the limitations of this approach. Sectoral policy is a blunt instrument for aiding target poverty groups. For example, smallholders may benefit rather little from improved producer prices, with most of the gains going to more prosperous producers, because the truly poor may produce little or no marketable surplus, having to concentrate largely on growing enough food for the family to eat. We should also recall from Working Paper 34 that it is easier to manipulate the producer prices of export crops than of foodstuffs whereas the poorest farmers are likely to concentrate largely on foods. Remember too that many of the poorest households will be net purchasers of food and they could be hard hit if improved producer prices spilled over into higher consumer prices. We should similarly not underestimate the difficulties, political and other, of executing meaningful land reform programmes. There have been many examples of apparently radical reforms coming to little as a result of resistance from those who stand to lose and there is today some scepticism about the feasibility of meaningful land reform in other than exceptional circumstances. Something of the same could be said of attempts to reorientate government support services in favour of poor smallholders.

These considerations caution against relying too much on agricultural policy and this caution is reinforced by the importance of non-farming sources of income for the well-being of the rural poor. Figure A illustrates for Botswana what is a general feature, that there is a negative correlation between the income of rural households and the proportion of income derived from off-farm activities, with transfer payments (typically from household members who have migrated to the towns) of special importance to the poor. In the longer term, access to education (and, to a lesser extent, to health services) is of fundamental importance to raising the incomes of the poor.

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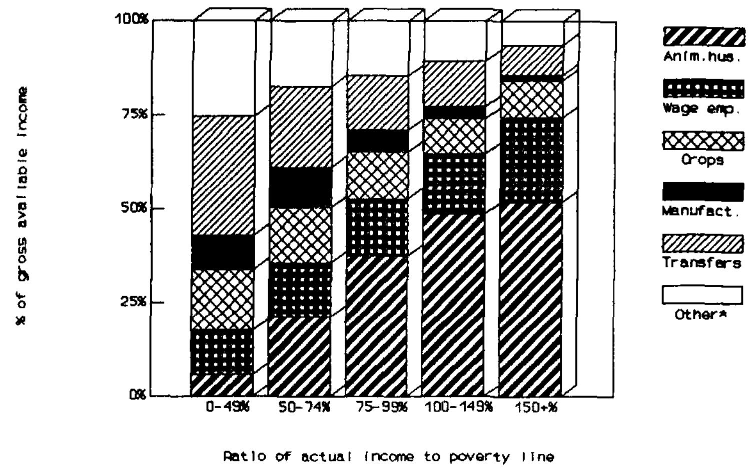
33 See Lele, 'Empowering Africa's rural poor: problems and prospects in agricultural development' in Lewis, 1988, chapter 3. The quote is from a summary of her contribution on p.29.

Figure A: **Distribution of Income by Source in Rural Botswana, 1975**



Notes: Poverty line varies with household.

* 'Other' covers trading & vending; services & construction; hunting & fishing; gathering; and property.

Source: Watanabe and Mueller [1984].

We have referred already to the unemployment that can arise from fiscal retrenchments and other aspects of adjustment programmes. Those affected can easily find themselves members of 'the new poor', suddenly deprived of what they had previously regarded as a dependable major source of income. A frequent palliative is to make redundancy payments to those who have lost their jobs and to offer retraining schemes. Some countries have devised special (temporary) employment schemes as a further response, of which the emergency employment programmes introduced in Chile in 1975-84 have sometimes been cited as promising models.[34] At their peak these provided employment to a full 13% of the labour force even though the total cost was only 1.4% of GNP. This was made possible by paying wages at below market rates, which had the further advantage that only the poor were interested in taking up such work. Such schemes can often have the disadvantage (as in Chile) that they do not offer genuine, productive employment - although it is sometimes possible to put such labour to productive use repairing or constructing roads, dams and other facilities - but they do help to cushion the shock of increased unemployment and give those affected more time in which to find alternative employment for themselves.

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[34] See World Bank, 1990, p.119, and Demery and Addison, 1987, pp.22-23.

What else might be achieved through the budget, particularly in the provision of social services? In the face of an often narrow tax base and acute budgetary difficulties targeting is the key word, *i.e.* introducing safeguards to ensure that those most in need of the services are the ones that actually receive them. This implies both precise identification of target groups and the design (or often the redesign) of services so that they actually reach these groups and meet their most pressing needs. The latter stipulation necessitates a shift away from services which disproportionately favour the urban middle class in favour of more primary health and education provision, rural water supplies, and low-cost housing.

The cost-efficient targeting of services is a difficult task, however.[35] Box V on food assistance programmes in Jamaica and Sri Lanka illustrates some of the difficulties, especially those of identifying the target group accurately, keeping records of it up to date, safeguarding against deception and excluding the not-so-poor. The administrative and informational costs of these tasks can be large. It can also be difficult to avoid creating disincentives for the poor to raise their earnings, leading to long-term dependency on social support, for they may find themselves no better off (and perhaps worse off) if their higher incomes reduce their eligibility for anti-poverty relief. There are also the political difficulties of excluding the relatively affluent which were already mentioned. However, these difficulties do not mean that targeting is invariably impractical, as Boxes IV and V make clear, and one resort which governments are increasingly using is to channel assistance through NGOs.

Two rather taboo topics should also be mentioned. With the ending of the Cold War at the beginning of the 1990s there was much talk among the major military powers of a 'peace dividend', referring to the possibility of diverting resources from military budgets which could no longer be justified because of reduced international tensions into more constructive social uses. Similar questions could be asked about the military budgets of a good number of developing countries. In a large number of them the cost of spending on the armed services exceeds the combined size of the education and health budgets and the military justification for this is often far from clear.[36]

Progressive taxation (*i.e.* based on ability to pay) is the second subject that has become rather taboo in recent years, because of the adverse effects that this can have on incentives and a less well defined belief that taxation is generally too high relative to total incomes. While it would be wrong to suggest that in the circumstances of low-income countries progressive taxation can bring about more than a small reduction in income inequalities, it would equally be wrong to ignore the fact that reluctance to tax can prevent governments from helping the poor adequately and that a heedless (but fashionable) shift from direct to indirect taxation can easily be regressive and impose serious additional burdens on the poor.

Reference to progressive taxation does, however, bring us to the existence of trade-offs between measures to protect the poor and other objectives of adjustment policy. In the case of taxation, the tradeoff is between raising revenues necessary for social

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35 See Besley and Kanbur, 1988, on this subject.

36 On this see UNDP, 1990, pp.76-78 and 162-63.

BOX V. TARGETED FOOD PROGRAMMES IN JAMAICA AND SRI LANKA [37]

Jamaica and Sri Lanka are among the countries which have introduced food assistance programmes targeted on poverty groups. Jamaica, for example, responded to problems created for those below the poverty line by policy reforms introduced in the early 1980s. The government decided that the budgetary situation dictated that a general subsidy of various foods would have to be abandoned. At the same time, heavy dependence on imports of food meant that devaluations raised food prices, and at a time when the real purchasing power of low-income families was tending to decline because of increasing unemployment. The government thus introduced a Food Aid Programme which included provisions for the feeding of school-children, food supplementation through health clinics and the distribution of stamps targeted on the elderly and very poor which could be used for the purchase of food. Sri Lanka also introduced a food stamp scheme to replace an insupportably expensive universal budgetary subsidy on various basic foodstuffs.

Both programmes were highly successful in reducing the claim of food subsidies on the exchequer. In Sri Lanka the cost of the subsidies declined from 5% of GDP in 1975-79 to under 1% in 1984; in Jamaica the reduction was from a peak of 6% in 1977 also to under 1% by the mid-1980s. But were they successful in protecting the poor? In some degree they clearly were but there were problems too. One of these concerned identification of the target groups. In Sri Lanka the group was identified by the size and incomes of households at a particular time without provision for striking out those who subsequently increased their real incomes or for adding new low-income families. Moreover, the face value of the stamps was not increased in line with prices, so their real value became eroded. In consequence, some who benefitted could have managed without while others who needed help slipped through the net. This contributed to a decline in real incomes among the poorest fifth of the population.

There were similar problems in Jamaica. Thus, all schoolchildren benefited from the school feeding programme, whatever the incomes of their parents, while some of the children of the poor secured no relief because they did not attend school. Despite these difficulties, however, there is no doubt that the poor received greater protection from these schemes in the face of very large general subsidy reductions than they would have done in the absence of special provisions.

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[37] This is based on materials in Demery and Addison, 1987; Besley and Kanbur, 1988; and the World Bank, 1990, chapters 6 & 7. See also Cornia *et al.*, 1988, chapters 5 & 9.

and economic expenditures that benefit the poor and the potential disincentive (or tax evasion) effects of higher marginal tax rates on work, saving and investment. Some, like the UNICEF team, are inclined to deny that trade-offs are a major problem [Cornia *et al.*, 1987, p.290]:

> *A strategy which protects the vulnerable during adjustment not only raises human welfare but is also economically efficient. Many studies have shown that investment in human resources is at least as vital for economic growth, and exhibits as high returns, as physical investment. All the main elements*

> *of the strategy [for protecting the poor] have been shown to yield positive economic returns - for example, worker productivity rises with improved nutrition; small-scale producers in both agriculture and industry have been shown to be as efficient, and often more efficient, than large producers. The most important factor explaining the great economic success of the East Asian countries is agreed to be the very high levels of human capital, resulting from comprehensive education and health systems.*

Others are less sanguine. We have already mentioned the potentially high administrative and informational costs of targeted welfare programmes, for example, and the choice that may have to be made between maintaining government social or economic services. And while it is true that <u>some</u> small-scale manufacturing and farming is economically efficient, this is less likely to be true of small-scale production by the very poor. Reaching poor, uneducated smallholders with extension and other public services can be both expensive and unproductive. Similarly, the literature on informal sector manufacturing does not support the contention that the type of enterprise run by the very poor can be induced to grow and modernise with only modest investments of assistance. On the contrary, they are liable to be among the victims of successful structural adaptation. We should also bear in mind a lesson from the industrial countries, already touched upon in the discussion in Working Paper 32 of defensive versus positive adjustment strategies and illustrated in Box I, that attempts to alleviate the social costs of adjustment often tend to preserve <u>existing</u> structures of employment and production, and to slow down structural change.

In short, the problem of trade-offs is a real one. This is not a reason for inaction, however, but for the careful design of programmes in order to minimise the costs and maximise the benefits.

III.4 <u>Adjustment and the environment</u>

The poor, it is said, are always with us. So is the environment, but a mounting tide of concern is being expressed about the effects of past policies on the quality of the environment and upon the sustainability of past approaches to economic development. We should therefore briefly consider the relationship between policies for adaptation and the protection of the environment.

Environmental considerations in fact made an appearance in the treatment in Working Papers 31 and 32 of adaptation to the greenhouse effect and other aspects of climatic change. There, however, we were taking such change as exogenous, beyond the direct control of national policy makers, and asking how they could help the economy adapt to it. Now we ask how adjustment policies themselves affect the environment. The answer offered is necessarily conjectural, however, for this subject only came onto the international agenda late in the 1980s and there has thus far been little published research.

From an economic perspective, we can view environmental issues largely in terms of: (a) <u>market failures</u>, chiefly in the form of external diseconomies, when pollution and other environmental damage is not reflected in producers' cost structures and is instead born by the wider community; (b) <u>state failures</u>, when government interventions (or failures to intervene) make things worse, as dramatised by the appalling environmental record of the former communist governments of various Eastern European countries; and (c) myopic inter-temporal choices which fail to give due weight to the future and result in unsustainable forms of development.

Against this background, we can offer the following suggestions. These particularly relate to the influence of a stable macroeconomic environment which we have emphasised at a number of points as being important for efficient adaptation.

(a) Economic stabilisation will, more or less by definition, reduce uncertainty, helping to foster confidence in the future. The odds are weighted against future generations when economic instability creates uncertainties so large as to undermine belief that postponement of consumption will actually benefit the future. For example, saving - hence investment in the future - will tend to be discouraged by high inflation. Future environmental costs will be heavily discounted; the bias will be in favour of consumption now.

(b) Macroeconomic stability is also good for the efficient working of markets. In turn, this increases the possibilities of avoiding environmental diseconomies by manipulating prices through use of taxes (*e.g.* on the principle of making the polluter pay the true cost of his output), because economic agents are better able to make rational decisions, and demand and supply elasticities will be larger (because price signals will be clearer, more dependable).

(c) Successful macro-management will reduce the risk of situations in which people experience periods of declining living standards, which cause them to place a very heavy premium on the present as against the future. This could be related to the present-day situation of a country like Brazil, which is being asked to defer short-term gains in favour of preserving the Amazon forest while at the same time its people continue to suffer major hardships because of the huge claims made upon national savings and export earnings by the cost of servicing its external debts.

(d) Economic stability creates a policy-making environment more favourable to pro-future decisions. The crisis-driven, day-to-day nature of policy-making in unstable economies is strongly antithetical to policy choices in favour of long-run environmental protection and planning. This will be particularly so if economic imbalances induce political instability, further shortening politicians' time horizons.

To the extent that they are valid, these propositions rather strongly favour the stabilisation and structural adjustment programmes supported by the IFIs that were adopted by many developing countries in the 1980s. Given the special importance for environmental protection of addressing the problem of state failures and of improving governments' abilities to intervene effectively in this area, the focus of these programmes on rationalising policy-making processes was potentially very valuable.

The positive thrust of the above is consistent with the conclusions of a study by Hansen [forthcoming] based on a study of 83 adjustment programmes supported by the World Bank and 10 by the Asian Development Bank. Among his chief findings were:

(a) Reductions in government spending incorporated in these (and associated IMF) programmes could have both harmful and beneficial environmental effects, with no reason to believe that they were, on balance, necessarily damaging to the environment.

(b) Measures to increase farmers' prices, commonly included in these programmes, can have mixed effects. In the case of tree crops the effect is likely to be favourable but when they favour annual cash crops or foodstuffs farmer practices determine the net effect. It could raise farmers' incentives and abilities to conserve the soil but it could equally lead to a damaging intensification of cultivation and erosion.

(c) Measures to reduce subsidies for agricultural inputs tend to benefit the environment by reducing excessive use of fertilisers and insecticides, and by discouraging mechanisation and the wasteful use of irrigation water, although the end result also depends on complementary measures.

(d) The common inclusion of measures to raise energy prices also tends to be environmentally beneficial, promoting conservation of fossil fuels and reducing emissions, although this effect is undermined if it triggers a substitution of fuelwood harvested from common land.

To these points we can add that the measures discussed in the previous section to protect the poor are also liable to have positive environmental effects. Their very struggle for survival in the face of ever-growing numbers tends to make the poor degraders of the environment, as a result of over-cropping and over-grazing, and the denudation of forest land. Measures which help the poor and reduce the pressures upon them thus also make some indirect contribution to protecting the environment.

Against this positive evaluation we should set some qualifications. First the relative shift in production in favour of tradeable goods (chiefly made in the agricultural, mining and manufacturing sectors) and away from non-tradeables (principally various service activities) usually incorporated in adjustment programmes is liable to be environmentally damaging, via intensification of cultivation, accelerated depletion of non-renewable assets and greater industrial pollution. Non-tradeable services are more environmentally friendly since they typically require only limited material inputs. Note, in relation to this, the strong connection between successful adjustment in developing countries and their success in exporting manufactured goods, as in the Eastern and South-Eastern Asian examples. More generally, this study has emphasised industrialisation as one of the 'enabling' components of structural transformation and there is a rather strong conflict between this and environmental concerns about greenhouse gases and other forms of industrial pollution.

Second, the short- to medium-term nature of IFI programmes (and the shortages of supporting finance which underlie it) can be detrimental by creating pressures for quick results, especially in export industries. Environmental concerns are liable to be thrust aside in the concern to meet Fund/Bank conditions and targets, of which the accelerated depletion of Ghana's tropical forests provides an example.

Third, in the 1980s much of the policy advice and conditionality of the IMF, the Bank and bilateral aid donors pushed in the direction of the disengagement of the state from the economy, playing down the role of planning and urging privatisation and deregulation. Given the often deplorable past record of such interventions, this orientation was fully understandable. But the externalities problem requires substantial state interventions on behalf of the environment and the long-term nature of environmental tasks requires the adoption of planning in some form, although not necessarily 1970s-style development planning. Although IFI structural adjustment programmes do tackle government failures, they have not necessarily had a focus ideal for addressing neglect of environmental protection.

This leads on to a political-economy point. A shift in the way that economies are run, away from state interventions and towards greater reliance on private enterprise, is not neutral with respect to how political systems will work. Dissimilar economic systems create different pressure groups, varying distributions of power. A shift in favour of markets and private enterprise will tend both to create a greater decentralisation of power and (to use a crude shorthand) to redistribute it in the direction of capitalists. This, in turn, will make it politically more difficult for governments to act against private sector polluters - a consideration which helps to explain the reluctance of various governments to take firm action against industrial polluters.

IV. MANAGING CHANGE

Politics have been floating just beneath the surface of this series of Working Papers, as the last paragraph reminds us. Let us now expose it to the light.

Politics is, in fact, central to structural adaptation. One of the most frequently recurring themes from earlier Working Papers is the crucial importance of the overall policy environment. We saw this in Working Paper 33, arguing that effective exchange rate policy was contingent upon a much wider range of policy actions, with governments' ability to manage a co-ordinated set of measures as a key determinant. We saw it in Working Paper 34 when discussing the influence of the overall policy environment as a source of industrial inefficiency and when describing the conditions that had to be satisfied for Export Processing Zones to stand a chance of success. We saw it in Working Paper 35 when setting out the fiscal and macroeconomic preconditions for successful financial liberalisation. It was for reasons such as this that we urged in Working Paper 32 the importance of viewing economic policies in the round, as an integrated system, as contrasted with a policy-by-policy approach.

Policies, then, are of crucial importance - and so, therefore, are the political processes from which policy choices emerge. This being so, the issue raised in Working Paper 32 of how we should view the state as an economic agent takes up centre stage. Should we think of it as motivated by a desire to find the most effective ways of promoting the general good of society or is it more realistic to view it as promoting special, rather than general, interests, if not actually predatory upon the economy? Clearly, the view we take of the desirable role of policies to promote adaptation hinges closely on how we answer that question. It arose, for example, in Working Paper 34, when we considered the scope for policies of industrial protection: do we trust the government to confine itself to such protection as can be economically justified?

In taking a view on such questions, however, we need to understand as well as we can the reasons for political resistances to change in order to identify what scope there might be for positive action and what types of action might be most effectual.

IV.1 Politics as an obstacle

The influence of political systems on long-run patterns of growth and change was among the issues explored by Kuznets [1966, pp.445-53] in the 1960s. Comparing the political structures of developing and developed countries he saw the latter as unstable, ineffectual and ambiguous about the merits of modernisation; less representative, less tolerant of interest groups, with power more concentrated and more personalised. Kuznets noted that modern economic growth was achieved in the nineteenth and twentieth centuries by countries which by the 1960s had political structures quite different from those then prevailing in developing countries. But he went beyond that to suggest that the characteristics just noted constitute formidable obstacles to economic progress in many developing countries: *'Political instability and nonrepresentativeness of the regimes, combined with an authoritarian structure dominated by personalist leaders and backed by familial and ethnic ties and the police, are hardly favourable conditions for economic growth'* (p.453). The influence of traditional values on governments and their resulting ambiguity about the desirability of modernisation observed by Kuznets is a situation which has been illustrated in the 1980s by the spread of an Islamic fundamentalism which appears to reject much of the modernisation model.

Of course, far from all developing countries have political systems with the characteristics mentioned above. Much has happened since the 1960s, particularly in Latin America. Moreover, there is no suggestion that there is some simple, mechanistic connection running from political modernisation to economic development. Nevertheless, there are enough resonances between Kuznets' observations and the contemporary scene for us to take his comments seriously, and enough developing countries have experienced adjustment difficulties that emanate from the political system for his warning to be underlined.[38] Indeed, a much more recent upsurge of concern about a crisis of 'governance' in Africa and elsewhere underlines some of his worries. Thus, the Khartoum Declaration of the Economic Commission for Africa [1989, p.7]:

> *. . . the political context for promoting healthy human development [in Africa] has been marred, for more than two decades, by instability, war, intolerance, restrictions on the freedom and human rights of individuals and groups as well as overconcentration of power with attendant restrictions on popular participation in decision making.*

Next the World Bank [1989c, pp.60-61]:

> *Underlying the litany of Africa's development problems is a crisis of governance . . . Because the countervailing power has been lacking, state officials in many countries have served their own interests without fear of being called to account. In self-defence individuals have built up personal networks of influence rather than hold the all-powerful state accountable for its systemic failures. In this way politics becomes personalised, and patronage becomes essential to maintain power. The leadership assumes broad discretionary power and loses its legitimacy. Information is controlled, and voluntary associations are co-opted or disbanded.*

Authoritarian, non-democratic systems of personal rule quickly lose legitimacy - acceptance by the public of the government's right to govern - and such loss of legitimacy seriously undermines the state's ability to adopt, and more particularly to sustain, adjustment policies. Such regimes are particularly likely to be 'soft' - despite the appearance of hardness and their often ruthless suppression of opposition - in the sense of being unwilling or unable to implement measures that may incur unpopularity.

We should also bear in mind the strength of the forces of inertia. An existing set of policies should not be viewed as accidental, nor as the outcome of purely technocratic considerations. Policies reflect the distribution of power and influence. Thus, the bias towards urban dwellers - and the difficulties, therefore, of shifting relative prices

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[38] See Sandbrook, 1986, for an exploration along these lines applied to sub-Saharan Africa, examining the implications of 'patrimonial' government for economic management.

in favour of agriculture - brought out in Working Paper 34 reflects the greater power and potential for creating trouble of those living in the towns. Similarly, we have in this Working Paper drawn attention to the political delicacy of reorienting policies in favour of politically weak poverty groups, of the difficulties of enforcing effective land reforms in the face of opposition from large landowners, and of anti-pollution measures in the face of a powerful industrial lobby. Discussion of the politics of environmental protection also drew attention to what is a considerably broader point: that the general thrust of our recommendations to rely more upon market forces pushes in the direction of a greater decentralisation of economic decisions which will alter the balance between the state and society in ways liable to be resisted by the institutions and agents of the state. We are reminded again of the difficulties of using the instrumentalities of the state to change policies in a less statist direction.

Policies based on the distribution of power often have great inertial force. They cannot easily be changed because those who benefit from them are influential enough to block reform. Among those potential beneficiaries are the employees of the state - the very bureaucrats who must execute policy reforms. Unless treated with care, they can be a potent obstacle to change, as was stressed in the discussion of implementation in Working Paper 32. Such resistance helps to explain why the World Bank has encountered particular difficulty in promoting the reform of institutions, for it is precisely this type of change that can pose a special threat to the privileges, or comfortable routines, of administrators.

Bureaucratic obstacles may also arise for the simple reason that in a good many countries civil servants' pay and conditions are appallingly bad, with governments typically preferring to maintain an over-large civil service which it is then unable to remunerate adequately.[39] In such circumstances, the best civil servants leave for more adequately rewarded jobs elsewhere. The rest become demoralised, 'moonlight' on second jobs so that they are often not in their government offices, or use corruption to augment their official incomes. This problem of inadequate incentives is compounded by an even more common weakness of civil services, of a frequently limited connection between an individual's performance and his reward or promotion. A government's ability to execute reforms with a depleted and demoralised civil service are severely limited, while budgetary pressures and the unpopularity of laying people off may prevent it from restoring adequate incentives.

We should further recall an observation made earlier. On the one hand, conditions of economic crisis may be politically necessary before the government can take, and the public will support, necessary action. On the other hand, policies adopted in such crisis conditions are less likely to have been carefully prepared, well chosen and to include adequate provisions for implementation.

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[39] For an excellent discussion of this problem, possible solutions and country illustrations, see Klitgaard, 1989.

IV.2 Countervailing forces and the cost-benefit balance

All this seems to make policy change impossible! Yet somehow changes do occur, progress is made. How can this be? An answer can be sketched along the following lines.

A kind of cost-benefit logic is at work. A proposed change of policies to facilitate structural adaptation - say a rationalisation of industrial protection - will generate costs and benefits, both economic and political. In terms of the political system, the way these are distributed within society will be of crucial importance. If most of the benefits are expected to accrue to the poor, the unorganised or those supporting the opposition, while the costs are expected to be concentrated on powerful groups of government supporters, the cost-benefit calculation is unlikely to encourage the government to 'do the right thing'. But if the industrial sector is widely regarded as grossly inefficient, if this is seriously penalising large numbers of the population and if the sector is stagnating, then the net balance of costs and benefits could point to a different resolution.

Much, in other words, depends upon the initial situation, how bad things have become, how widely the existence of a problem has become recognised, and who is blamed for the mess. There are times when things have to get worse before they can get better, but if things get bad enough even the most conservative or timid government may begin to see change as being in its own interests, because the existing situation is unviable and it can only be a matter of time before unchecked economic deterioration generates widespread public hostility to the government. Even more frequently, perhaps, a new government is swept to power on a wave of economic discontent.

The business community may play a key role, for that is usually a very influential group. Continuing with the industrial protection example, in normal times industrialists can be relied upon to resist the reform of protection but if the condition of the manufacturing sector gets parlous enough they too may come to favour change and are likely to be in a position to exert pressure on the government to take action, or for political change if it will not. The urban wage labour force may occupy even more of a strategic position. Governments are often specially nervous of this group, because of its ability to mount highly visible, sometimes riotous, protests in the capital and other major cities. Often it will be a force against change but again that may alter if things get bad enough.

This tendency for a deteriorating balance of economic costs and benefits to set up countervailing pressures for political change is, in fact, a strong finding of the most substantial study so far undertaken of the politics of adjustment [Nelson, 1989 pp.11-12]:[40]

> *Among those governments pursuing particularly far-reaching programs of economic reorientation in the 1980s (plus a few cases from the 1970s), most share important political features. Consider Chile after 1973, Sri Lanka from 1977 to the early 1980s, Turkey and Jamaica since 1980, Ghana since*

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[40] See also Nelson, 1990, for additional country materials.

> *1983, and the Philippines since 1986. All of these countries had suffered long periods - in Ghana's case, two decades - of economic stagnation or decline or of deepening financial crisis, coupled with increasingly widespread political alienation and/or polarisation and violence. In each, in the years noted . . . a new government took office, elected with overwhelming majorities in Sri Lanka, Jamaica and the Philippines; and taking power in military coups but with considerable or sweeping public support in Chile, Turkey and Ghana. In all of these countries, there was clearly widespread support - indeed demand - for major changes, although there were deep divisions in every case regarding the nature of the needed reforms.*

What her last sentence implies, however, is that successful reform is likely to need more than a favourable cost-benefit balance. She goes on (p.12) to write of a reform syndrome:

> *Leaders firmly committed to major change, widespread public acceptance or demand for such change, new governments with strong centralized authority, and a disabled opposition constituted the political context for determined adjustment efforts.*

The quality of leadership is a factor that she emphasises.[41] This includes a willingness on the part of the head of government and his colleagues to influence and prepare public opinion; to initiate change; shrewdness in the phasing of policy changes, to avoid upsetting too many groups at once and to keep potential opposition groups isolated from each other; a willingness to offer compensation to those who may lose from the reforms and who could make political trouble. Her reference to the desirability of a strong centralised government is perhaps more problematical, for we have suggested at a number of points that authoritarian governments are apt to lose legitimacy and hence the ability to sustain pro-adaptation policies over time. Most features of the reform syndrome are illustrated in Box VI on Ghana.

Box VI on Ghana provides an extreme illustration of the message with which we close this book: of the enormous superiority of a steady, long-term adherence to policies which promote continuous adaptation by comparison with a process which first has to generate an major economic crisis (with all the human suffering that creates) before it is possible to introduce the draconian measures which by then have become unavoidable. The reform syndrome is an extremely inefficient path to adjustment. The costs are very high, political as well as economic. Governments which finally take the risk of grasping the reform nettle deserve credit. But the governments - and political systems - which deserve the highest praise are those that throughout recognise the need for change and adaptation and which, by so doing, avoid the trauma of an economic collapse as a necessary prelude to adjustment.

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[41] Consistent with this, Horowitz, 1989, p.207, suggests there is more scope for the exercise of political leadership in developing country conditions, where the strength of the central government may be greater *vis-à-vis* organised interest groups than in the more highly articulated societies of the industrial world. Support for this proposition comes from a study of agricultural policy change in India by Varshney, 1989, who argues that the state had considerable degrees of freedom to initiate changes (a) because existing policies were widely agreed to be failing and (b) because interest groups had not coalesced in defence of the *status quo* or in favour of particular solutions.

BOX VI. THE REFORM SYNDROME IN GHANA [42]

On the last day of 1981 a group of military officers headed by Flight Lieutenant Jerry Rawlings seized power for a second time, overthrowing a civilian government to which Rawlings had transferred power two years earlier. By instinct and conviction Rawlings was a radical populist, espousing the doctrines of Ghana's first President, Kwame Nkrumah, and sceptical of the economic orthodoxies associated with the IMF and World Bank. The economy, however, had been in decline for most years since the early-1960s and twenty years later was in a desperate condition, with triple-digit inflation, a grossly inflated exchange rate (the black market rate reached thirty times the official rate), acute shortages of all types of imports, an industrial sector nearly at a standstill, a crumbling infrastructure, a massive haemorrhage of educated manpower out of the country, and per capita incomes a third lower than in 1970. In fact, it represented a classic case of an economy whose inherent structural inflexibility had been worsened by years of mismanagement and resistance to adjustment by a succession of governments.

A drought, widespread bush fires and an enforced mass return of Ghanaian migrants from Nigeria turned a crisis into a catastrophe. Rawlings and his advisers began to realise that the measures they had in place could not cope with this situation and how desperately they needed the financial support of the IFIs. Moreover, the depths to which the economy had descended - and the privations this was forcing upon the mass of Ghanaians - created a desperation of opinion that was willing to accept any change that would offer the prospect of economic recovery. In 1983 the government therefore turned for help to the IMF and World Bank. Since that time it has executed a succession of conventional adjustment programmes. These have included a huge effective devaluation of the currency, the cedi, from C2.75 to the dollar in 1982 to well over C300 by mid-1990. They also included greatly increased producer prices for cocoa farmers and other exporters; measures to reduce government spending and to bring it under better control; the reform (and in a few cases, privatisation) of public enterprises, including large-scale reductions in the hugely inflated payroll of the Cocoa Marketing Board; rehabilitation of the infrastructure; and the partial liberalisation of imports and the financial system.

This set of policies marked a sharp break both with the tradition of post-Independence economic policies and with Rawlings' own predilections. Nevertheless, his government has been consistent in its adherence to the course it adopted in 1983 and by 1990 could point to a major economic recovery as a result. Their fortitude was, however, made easier by a highly centralised and authoritarian style of government. The human rights record of the government was initially bad and has remained poor. The media are kept under strict government control. Political parties and other forms of organised opposition are banned. There is no clear timetable for a return to civilian rule.

The Ghanaian case thus incorporates all the ingredients of Nelson's description of the 'reform syndrome': leaders firmly committed to major change; widespread public acceptance of the need for this; a strong, centralist new government; and a disabled opposition. By the beginning of the 1990s some cracks were beginning to show, however. In particular, there seemed to be a contradiction between the broadly decentralising thrust of post-1983 economic policies and the continuing centralist style of government. Rightly or wrongly, it was widely believed that most of the benefits of the recovery of the economy were being concentrated on a limited number of the population. There was uncertainty about how much popular support the Rawlings administration retained and about future political developments, and this was contributing to a sluggish response by private investment to the improved framework of economic policies. The sustainability of the reforms still appeared fragile.

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[42] Interested readers should refer to a comparative study of the politics of adjustment in Ghana, Nigeria and Zambia by Thomas M. Callaghy in Nelson, 1990, chapter 7.

V. SUMMARY

Among the wider contextual issues taken up in this Working Paper, the first related to the feasibility of adjustment-in-one-country, or the consistency of the global economic environment with national adjustment efforts. We pointed out a number of asymmetries in the system, the double standards sometimes applied by industrial countries, and the retreat during the 1980s from international co-operation. The effect of these distortions was to impart some deflationary bias to the global economy and to thrust a disproportionate share of the costs of adjustment on low-income countries. Even if systemic reform of the international system is impracticable, specific policy changes by industrial countries could improve matters, including reform of their policies on market access and protectionism, measures to reduce pressures for continuing over-supply on commodity markets, and greater financing for export compensation schemes. We also drew attention to ways in which the overhang of external debt and shortages of supporting finance in many developing countries undermined their adjustment efforts, urging upon donor and creditor countries more generous, imaginative and flexible policies with respect to the provision of aid and debt relief.

With financial assistance come policy conditions, however, and we turned to examine some of the issues arising from conditionality, particularly that of the IMF and World Bank (IFIs). It was suggested that the overriding impact of the policy environment on the effectiveness of assistance gave the donors/creditors a legitimate interest in recipient policies, that IFI conditionality generally tried to move policies in a sensible direction and, in any case, that there was no convincing and thorough-going alternative approach available. However, experience has not provided strong evidence that conditionality is actually very effective in achieving its objectives.

There are a number of sources of weakness. Some of these are technical, *e.g.* relating to the complexities of designing adjustment programmes, and the difficulty of striking an appropriate balance between the regulation of aggregate demand and the promotion of supply-side reforms. Difficulties in donor-recipient relationships are another source of weakness. They may differ over objectives. The fact of conditionality may weaken a government's sense of 'ownership' of a programme. And there are difficulties about the short-to medium-term time horizons of IFI programmes. We concluded that conditionality probably has the most effect when IFI intervention tips the domestic policy-making balance in favour of reform but that in other circumstances it risks being impotent or actually harmful.

We then turned to more domestic aspects of the wider context. The first concerned the impact of adjustment measures on the poor. Adjustment costs were classified into absorption costs (the losses of output and income associated with reductions in consumption and/or investment necessary to restore macroeconomic balance), frictional costs (resulting from shifts of resources from declining to expanding sectors) and distributional costs (when adjustment is associated with a change in poverty and inequality regarded by society as undesirable). We also noted an inter-generational element, when adjustment costs are shifted onto future generations, *e.g.* by cutting back on present investment rather than consumption.

Adjustment endangers the poor in a number of ways: through job losses, cut-backs in state spending on food subsidies and social services, and the adverse effects of an economic slow-down. Moreover, the poor are rarely politically powerful, which increases their vulnerability. Even when they wish to, most governments find it difficult to assist the truly poor but this can be done by measures which increase their access to productive assets; raising their returns from the assets they already possess; improving their employment opportunities; improving their access to education and health services; and supplementing their resources with transfers. Policy can be brought into play at all levels and one fundamental principle is that measures to protect the vulnerable need to be integral to the design of adjustment programmes, rather than being added on as supplementaries. A number of more specific measures were discussed: job-creation schemes; the targeting of food subsidies and other social provisions; utilisation of the 'peace dividend' from reduced military spending; and progressive taxation. However, trade-offs do exist between measures to protect the poor and the adjustment of the economy, which emphasises the need for careful policy planning.

Consideration of the environmental effects of policies of adaptation suggested that adjustment was a generally positive factor, particularly by creating an economic environment favourable to longer-sighted decisions. However, this overall judgement had to be qualified in a number of respects: a shift in favour of tradeables, particularly in the direction of industrialisation, the thrust of programmes in the 1980s towards a relative disengagement of the state, and a probable resulting shift of political power towards the capitalist class were all identified as having potentially adverse environmental consequences.

Finally, we turned to examine the politics of adjustment, which is central to the whole process. It is easy to see political realities as barriers to adjustment. Governments which have become insecure, corrupted, repressive are unlikely either to give much priority to economic adaptation or to have the legitimacy necessary for adjustment policies to be executed and sustained. Existing policies - however ill-chosen - often have large inertial power because those who benefit from them become powerful enough to block change. The civil service can itself be a major force against change. In some cases this arises from grossly inadequate pay and conditions.

But change is not impossible. A cost-benefit logic is at work, in which the economic deterioration that results from anti-adaptation policies throws up a countervailing public discontent which will either impel the government to act or replace it with a more reform-minded successor. When combined with a strong leadership and government, such public acceptance of the need for change can render politically feasible policy shifts that would formerly have been judged suicidal. Ultimately, economic flexibility has more friends than enemies but a sustained, continuous encouragement of flexibility is a policy stance far superior to a syndrome which needs an economic crisis to set it into motion.

Guide to further reading: Parts I and II draw fairly heavily upon my essay in Bird (ed.), 1990, and other contributions to that volume are also useful, especially those by Bird himself. The World Bank's [1989a] evaluation of the results of its adjustment lending is useful; see Khan, 1988, on the methodological pitfalls of programme evaluation. On adjustment and poverty, the best succinct treatment is Demery and Addison, 1987. The World Bank's 1990 World Development Report also contains valuable material - see especially chapters 7 and 8. The seminal contributions by the UNICEF team are in Cornia *et al.*, 1987 and 1988. By far the best sources on the politics of adjustment are Nelson (ed.), 1989 and 1990; but Perkins and Roemer (eds) [1991 forthcoming] contains a useful collection of papers, including Grindle and Thomas's illuminating essay, also published separately in 1989.

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