PART FOUR

E[illegible] ST CL[illegible]S

TO CHANGE

CHAPTER 9

THE CHALLENGE OF INITIATING AND SUSTAINING REFORMS

The innovator makes enemies of all those who prospered under the old order, and only lukewarm support is forthcoming from those who would prosper under the new.

—Niccolò Machiavelli, *The Prince* (1513)

PRECEDING CHAPTERS HAVE SHOWN HOW THE STATE can improve its effectiveness by matching its role more closely to its capability, and working to enhance that capability over time. Integral to this approach is a better understanding of why some countries do not meet even the most basic requirements for sound economic management, and why so few developing countries have managed to create effective state institutions. But understanding the problem and fixing it are two very different things. The basic questions remain: why and how is it that some countries have been able to throw off this legacy of failure and move forward with reform, while others have not?

This chapter looks for some answers to these questions by examining the main obstacles to reform and how they can be overcome. Three factors turn out to be critical: the distributional characteristics of reform (the likely winners and losers), the political strength of key groups (particularly those that will lose out), and the design of existing state institutions. Sometimes a reform will be politically undesirable because the likely losers are part of the political leadership's support base. Even when the political will to change is present, reformers can find their efforts derailed by constraints embedded in state institutions, which make it easier for opponents to maintain the status quo.

But the fact that opposition to reform can be rooted deeply in a country's institutions need not be a counsel of despair. To the contrary, close examination of the impediments to reform yields three pieces of practical advice for reformers. The first is that windows of reform opportunity do open; they tend to be those times when the normal rules of the game are in flux for some reason, however temporary. Thus, radical reforms have often been undertaken in response to an external threat or economic crisis, or during the "honeymoon" period of a new administration or regime, when incumbents with a strong vested interest in the old system have been displaced.

The second lesson is that, given such an opportunity, reformers can make the best use of the time available by adopting a strategy that understands the likely obstacles and seeks to mitigate them. Tactically designing and sequencing the reforms can help, as can measures to make institutions less susceptible to capture by special interests and gridlock, and, perhaps most important, building a consensus in favor of reform.

Finally, the message of the many reform successes—and failures—analyzed in this chapter is that breakthroughs will rarely happen by accident. At any given time, the forces favoring the status quo are likely to prevail. Reforms only succeed if they are directed by leaders with a clear vision of the way things could be, and a contagious determination to turn that vision into reality.

Obstacles to reform

The obstacles to reform in any country will be many and varied. The recipe for reform failure is no more susceptible to easy generalizations than the recipe for success. But chief among the barriers to change will always be the powerful interest groups who stand to lose by it. Resistance will be even stronger when the prospective losers are among the political leadership's core constituents. In short, the redistributive effects of a reform and the political strength of groups affected by it may simply render some policy changes politically undesirable. Yet even politically desirable reforms may fail because of constraints embedded in state institutions, which tilt the playing field firmly in the opponents' favor. Thus, policy outcomes can usually be seen as the combined effect of the characteristics of the reforms themselves, the political strength of different actors, and the design of existing state institutions.

Distributional conflicts, [illegible] and reform

Some common types of reform and the groups that stand to gain or lose from them are listed in Table 9.1. These alignments do not apply in all circumstances. But the truth remains that resistance to reform is often triggered by the potential redistribution of resources among different groups, whose precise composition will depend on the reform in question. For example, public sector reform, which is central to reinvigorating state institutions, can sometimes be thwarted by civil servants who run the risk of unemployment or finding themselves worse off in private sector employment. Politicians who use public employment as a source of patronage may also see an interest in blocking certain kinds of reform. Decentralization, for instance, raises the prospect of reallocating resources outside the political leadership's constituency. In Peru, a decentralization program that would have transferred resources for financing primary and secondary education to provincial municipalities was halted in 1993, following widespread victories by independents and opposition parties in the municipal elections.

Table 9.1 Alignment of interest groups, political costs, and tactical sequencing of reform by reform type

	Interest groups				
Type of reform	**Against**	**For**	**Determinants of political cost**	**Tactical sequencing**	**Other issues**
Trade liberalization	Holders of import quotas Protected industrialists	Consumers, exporters, the treasury (if revenues will increase)	Redistribution (+) Efficiency gains (−)	Reduce quantitative restrictions before tariffs.	
Pension privatization	Trade unions Pensioners associations Bureaucracies (labor ministry, social security agency)	Employers Financial institutions Young workers	Wealth reduction (+) Reduced coverage (+) Older median voter (+) Efficiency gains (−)	Allow participants to opt out of public scheme, then phase it out.	Young workers may be willing to forgo some of their acquired rights.
Decentralization					
Functional	Top officials and staff in central administration	Top officials and staff in local administrations, consumers, citizen beneficiaries, local businesses	Redistribution (+) Political contestability (+) Efficiency gains (−)	Build consensus, phase in pilot program, design grant schemes	Need to mitigate fiscal imbalances and design new schemes for allocation of grants across jurisdictions
Political	Top decisionmakers in political parties	Local decisionmakers in political parties, associations, and labor unions, NGOs, taxpayers			
Fiscal	Top officials in ministry of finance and strategic planning (or public investment) commission	Department of finance in local administration, local planning and investment units			
Public sector reform	Employees and managers of public enterprises, politicians prone to patronage	Private business, rural elite, central agencies, taxpayers	Redundancy (+) Unemployment (+) Relative wages (+) Efficiency gains (−)	Eliminate ghost workers, encourage voluntary and early retirement, ensure retrenchment without revolving door	Incentives: severance, buyouts, capitalization scheme, training, private sector placement, credit schemes

Note: A plus sign indicates a factor that increases, and a minus sign one that lowers, the political cost of reform.

Ranking policy changes according to their political costs and benefits can help policymakers design the tactical sequencing of a comprehensive reform program. Although such an exercise is highly country specific, a good starting point is to compare the expected redistributional effects of planned reforms with their expected efficiency gains. Some reforms, for example, are difficult to implement because in the short run they seem to be merely reshuffling opportunities and incomes. Although such reforms, if they increase efficiency, ultimately increase the size of the pie, their short-run redistributive effects may exceed even the immediate benefits. In that case, other things equal, reform will not occur, because the political difficulties of reforming outweigh the rewards. This political cost-benefit approach can be applied to a broad range of reforms, such as trade liberalization (Box 9.1).

Applying the redistributional calculus to the case of pension reform shows how conflicts of interest across generations can also affect policy outcomes. Most public pension schemes are unfunded, financed by current payroll taxes rather than past contributions. The resulting high marginal tax on labor and the weak link between contributions and benefits create distortions in the labor market. In mature systems these distortions are compounded by the low implicit return on pensions relative to the market return on capital. The distortions could be reduced by, among other things, strengthening the link between contributions and benefits and privatizing and funding pension schemes. But such reforms would affect different generations of workers differently. For example, privatizing and fully funding the U.S. Social Security system could generate net gains, including gains in efficiency, but younger workers would realize most of those gains, and older workers would lose (Figure 9.1). This dilemma helps explain why reform is so politically sensitive. Similarly, redistribution away from the elderly helps explain why countries in CEE and the CIS are resisting increasing the pension age. In Ukraine, for example, a uniform pension age of 65 would ease the system's actuarial imbalance but would also reduce the pension wealth of workers (in present value terms) by about 25 percent of GDP.

The difficulty of reforming universal pension programs thus stems from the anticipated reform's redistributive effects and the power of elderly voters. Meanwhile unborn generations, who would benefit the most from reform, have no voice in the decision. The political costs of reform in the United States have risen over time, as the gap in voter turnout between the young (those between 25 and 40 years of age) and those over 65 has widened in favor of the latter, to some 12 percentage points. Clearly, reforming public pension and health care financing programs for the elderly, however fiscally unsustainable, is a difficult feat to pull off, but should be a high priority. Even when one-time, comprehensive reform is not feasible, more-gradual changes and grandfathering of existing beneficiaries, in the recognition that changes are likely to be generational, with long lead times, may reduce opposition to reform.

In many countries utilities are inefficiently run public monopolies. Consumers would realize significant gains if these utilities were privatized and effective regulatory agencies established to watch over them. Witness the case of Argentina, which began privatizing its state-run infrastructure services in 1989. All income groups have benefited from the efficiency gains induced by privatization, and these gains (relative to spending on utilities) have been similar across income groups (Table 9.2). In Uruguay, for example, a 1989 plebiscite rejected privatization legislation. Yet a recent study shows that inefficiencies in public utilities add 30 percent to the average Uruguayan's electricity, water, and telephone bills. And as

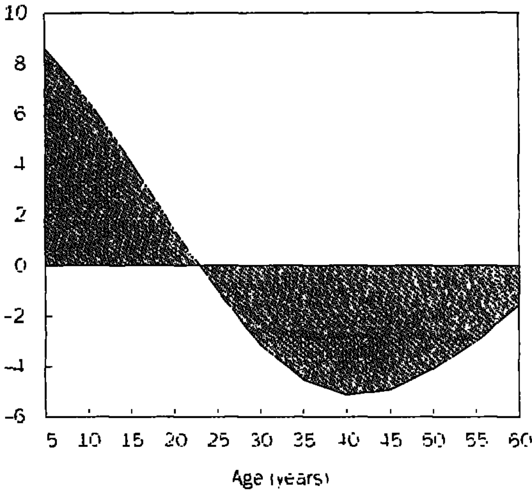
Box 9.1 Weighing the political costs and benefits of reform

Efficiency-enhancing reforms are often difficult to implement because they create both winners and losers, and there may be no way to compensate the losers. Defusing opposition is even more difficult when the efficiency gains are low relative to the redistributive effects. Applying a rough political cost-benefit ratio to reform measures can show how much redistribution takes place for a given amount of efficiency gain. A policy that increases the income of one group without taking income away from another, for example, would have a ratio of zero.

For trade liberalization the political cost-benefit ratio is inversely related to the tariff rate, the share of imports in total consumption, and the elasticity of import demand. In Sub-Saharan Africa the average import tariff exceeds 30 percent, and the share of imports in total consumption is about 40 percent. Assuming an import demand elasticity of two (demand for imports rises by 2 percent for every 1 percent decline in price), the cost-benefit ratio of trade liberalization is more than four. Thus, for any given amount of efficiency gain, the redistributive effects would be four times that amount. When a reform program combines trade liberalization with a stabilization program that increases output, the ratio declines significantly. A stabilization program that increases GDP growth by 1 percentage point would be sufficient to lower the ratio from four to less than one.

Figure 9.1 Older workers will lose from reforming pensions, but the young will gain

Projected net gains from pension privatization in the United States (thousands of dollars per contributor)



Note: Data are aggregate lifetime gains or losses at 1995 present value using a 5 percent discount rate. Source: Feldstein and Samwick 1996.

we saw in Box 4.2, many of the arguments commonly offered against privatization are not valid.

So why is privatization still resisted in some countries? This reluctance to implement welfare-improving reforms is linked to at least three factors:

- The perceived uncertainty of the outcome of reform, which impedes the creation of a strong constituency for reform and raises concerns that the immediate response may be social unrest, while the benefits are only realized later
- The fact that private operators typically have to make changes that are detrimental to certain groups in order for the efficiency gains to materialize
- The fact that different groups may hold conflicting views about the role of the state—for instance, in many countries that have previously relied entirely on state utilities, many groups continue to resist privatization on ideological grounds.

Institutional design

The preceding discussion has identified the losers from reform as potentially powerful obstacles. But whether or not these groups prevail in a given instance will often be determined by the design of state institutions. Rather than attempt an exhaustive account of how state institutions can be used to block reform, we focus here on two principal ones: the electoral and party system and the system of checks and balances. The point is not that institutions should be redesigned and changed frequently to facilitate reform, or that a single design is desirable for all countries and situations. The aim, rather, is to show how elements of the underlying institutional framework can condition both the attempt to reform and the response.

ELECTORAL AND PARTY SYSTEMS. As has been emphasized throughout this Report, institutional choices are seldom clear-cut: they will involve a careful tradeoff between allowing state officials flexibility and imposing appropriate restraints on them. Experience with proportional electoral systems is a case in point. Such systems are associated with coalition governments, which can be desirable to the extent that they bring more voices to the cabinet table and put a high value on consensus. Yet the same characteristics can also be a barrier to reform, leading to long delays in policymaking and higher fiscal deficits because of the need to buy off sectoral or regional interests. Research has shown that countries with large and fragmented coalitions tend to have more difficulty adjusting to external shocks, such as the 1973–74 oil price hikes. Both Belgium's and Italy's very high levels of public debt have been partly attributed to two decades of being governed by large and unstable coalitions.

Brazil provides another illustration of how electoral and party systems can interact with economic policy. The social security bill proposed by the administration of President Fernando Henrique Cardoso in June 1996 was defeated in the lower house of the legislature, despite a formal majority in favor of the government alliance, because certain interest groups (civil servants and teachers, among others) exploited constitutionally protected privileges and a political system that discourages stable voting majorities in the congress. The fact that deputies belonging to the alliance voted against the bill reflects the

Table 9.2 Estimated efficiency gains from privatizing utilities in Argentina

Income quintile	Efficiency gains (millions of 1993 dollars)	Gains per dollar of expenditure on utilities (percent)
Poorest	205	30
Second	222	27
Middle	342	34
Fourth	335	27
Richest	549	31
Total	1,653	30

Source: Chisari, Estache, and Romero 1996 unusual autonomy of elected officials from political parties that characterizes Brazil's system of proportional representation. A 1991 study of Brazil's electoral and party system found that representatives had belonged to an average of three political parties, and that in 1987–90 one-third of the 559 representatives had switched parties since being elected in 1986. A bill to reform some aspects of party legislation may be voted in the congress in 1997.

In Uruguay a number of institutions have speeded some reforms—and held back others. One of the peculiarities of the country's electoral system, prior to the recent reform, was that party primaries and general elections were held simultaneously. As a result, the winning presidential candidate received only a minority of the total vote and had to build alliances with opponents in the parliament. In the November 1994 election the winning candidate received only 24 percent of the vote, and the three main parties each received more than 30 percent. Such an electoral system tends to be candidate centered and conducive to faction. Hence, groups that are able to mobilize politically reap the most benefits. Another distinctive feature of Uruguay's political system is its heavy reliance on direct democracy (through plebiscites) to decide on features of the public pension system. In 1992 voters reversed major privatization legislation. And a 1989 plebiscite, initiated by the association of pensioners, guarantees full wage indexation every three months. These institutional designs help explain why pension expenditures relative to GDP are about 35 percent higher in Uruguay than in the United States, even though the two countries have roughly the same proportion of elderly in the population (16 percent).

Uruguay has since recognized that its electoral system is an impediment to a well-functioning state. A new system was approved by the parliament in October 1996. It would end simultaneous voting for primaries and general elections, and it would require a second-round ballot between the two presidential front-runners when neither has managed to secure 50 percent of the vote. These changes are expected to strengthen party discipline and deter factionalism.

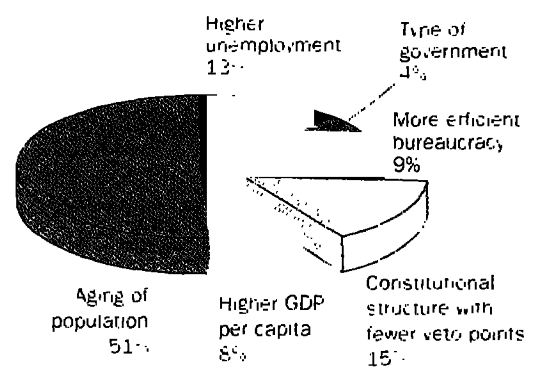
CHECKS AND BALANCES. Chapter 6 showed how and why inadequate checks and balances can lead to arbitrary government decisions and behavior. The veto points arise at three levels: the separation between the legislative and the executive branches, the division of the legislature into separate chambers, and the division of power between national and subnational governments. A bias toward the status quo develops when the state supports many institutional veto points, and groups that oppose change can exert power at one or more levels. In a presidential system, for example, gridlock can emerge when different parties or coalitions control the executive and the legislature. Similarly, as Chapter 7 showed, an ill-designed decentralization that leads to capture of local authority by special interests can prevent the adoption of sound reforms.

Although the presence of many veto points can sometimes contribute to delays, some evidence suggests that it has helped contain the expansion of the welfare state. As Figure 9.2 shows, the constitutional division of power ranks second only to aging in explaining changes in welfare spending. As incomes per capita increase, demand for government transfers also rises. Countries with fewer veto points in their state structure (such as Sweden and Denmark) are more receptive to these demands. By contrast, the greater number of veto points in Switzerland—a federal state with a bicameral legislature—has blocked many initiatives to expand welfare programs. Reforming the welfare state will therefore require going beyond streamlining the functioning of transfer programs. Indeed, this was recognized by the 1992 Swedish commission on state reform, which recommended strengthening the executive by introducing a constructive vote of no confidence, allowing the government to ask parliament to vote on measures as a package rather than line by line, extending the time between elections from four to five years, and reducing the size of the parliament by half.

POLITICAL REGIME. The choice of political regime has justifications that go far beyond economic conditions. Yet the strong links between state institutions and policy out-

Figure 9.2 Multiple veto points help countries resist pressure to expand welfare

Contributors to welfare expenditure



Note: Each slice represents the estimated contribution of that factor to observed government expenditure on pensions, unemployment benefits, and family assistance. Results are based on a regression on data from twenty-two OECD countries for the period 1965–93. See the Technical Note for details.
Source: World Bank staff calculations.

Box 9.2 The predatory state under the Duvalier dynasty in Haiti

Haiti became independent in 1804. A predatory state arose there between 1843 and 1915 a period characterized by short-lived rulers, often removed by coups, driven by the creation of personal wealth. Of twenty-two administrations during that period eleven held office for less than a year, and only one managed to complete its term.

The United States occupied the country from 1915 to 1934, but the logic of a predatory state remained unchanged. In 1957 the democratically elected government of François (Papa Doc) Duvalier took that logic to a new level, starting with an unprecedented purge of civil society, the inherited army, political opposition, and other branches of government. Within two months of coming to power, Duvalier had jailed 100 political opponents. The Catholic Church was perceived as a threat, and spiritual leaders were expelled. The mass media were silenced through the expulsion of foreign journalists, and a 1958 code allowed the government to shoot reporters charged with spreading "false news." Imprisonment of the parents of striking students was made mandatory. After lifting parliamentary immunity in 1959, Duvalier dissolved both the Senate and the Chamber of Deputies. Modern military equipment was stored in the basement of the presidential palace, and more than 200 officers were removed in Duvalier's first eleven years of power. In 1964 Duvalier declared himself president for life.

The economic pillars of Haiti's predatory state were expropriation, extortion, the inflation tax, and corruption. Following a business strike in 1957, the police were authorized to open the shops of striking merchants and distribute their merchandise. Significant resources were devoted to protecting Duvalier himself: 30 percent of total expenditures during the first half of the 1960s. Agriculture, particularly coffee, was heavily taxed. Some sources estimate that Duvalier transferred more than $7 million a year out of Haiti for personal purposes. Large-scale bribes also took place through deals with foreign investors on projects that often never materialized. Extortion under the veil of "voluntary" donations was institutionalized under the Mouvement de Renovation Nationale. A pseudo-old-age pension with a 3 percent deduction was created, and government employees were forced to buy a $15 book containing Duvalier's speeches. An autonomous government fund collected taxes and levies, which were excluded from the budget, and no accounting was made of their use.

After nearly thirty years of rule, the Duvalier dynasty fell in 1986, when Jean-Claude (Baby Doc) Duvalier, who had inherited the presidency from his father, went into exile in France with an estimated $1.6 billion at his disposal. Haiti's history as a predatory state goes a long way toward explaining its dismal economic performance. During 1965–90 growth in GNP per capita averaged −0.02 percent, and social indicators remain the worst in the Western Hemisphere. Given the legacies of the predatory state, Haiti's history remains perhaps the biggest obstacle to change.

comes raise the question of whether obstacles to reform may be embedded in the political regime. Some observers have argued that nondemocratic regimes, by having fewer veto points, are more conducive to economic development. The reality is more complicated: no single type of regime can guarantee economic and social progress. We do know, however, that one kind of regime—the so-called predatory state—can be almost guaranteed to produce economic stagnation. The focus of such a state is on the extraction of economic rents from the citizenry by those in power. It does so by specifying property rights in a way that maximizes the revenue of the group in power, regardless of the impact on the wealth of the society as a whole. Haiti under the Duvalier regime (Box 9.2) and Romania under Nicolae Ceausescu are prime examples. A predatory state is inconsistent with economic development because it discourages productivity and leads to misallocation of resources, culminating sometimes in the collapse of the state itself.

The end of the Cold War, combined with pressure from citizens, should lessen the risks of extreme state capture embodied in a predatory state, with many countries now having adopted elements of democratic regimes (such as free and open elections). But researchers have yet to reach a consensus on the precise relationship between growth and democracy: about one-fifth of the studies find a positive relationship, one-fifth a negative relationship, and the rest are inconclusive. The analysis of the determinants of growth summarized in Chapter 2 found no statistically significant correlation between the two. And certainly, economic performance among developing countries classified as sustained democracies has varied considerably.

The experience of countries that have combined political transformation with the transition from a planned to a market economy suggests equally mixed conclusions with regard to the relationship between democracy and reform. As noted in Chapter 7, using the ballot box to punish or reward politicians for past performance (retrospective voting) could be a powerful way to ensure accountability and good policy outcomes. But the road can be rocky at first. Indeed, governments' initial reaction to greater political contestability may add to the difficulty of improving institutions, and transitions to democracy are sometimes associated with increased budget deficits and inflation.

Sub-Saharan Africa has witnessed about twenty-seven elections since 1990, twenty-one of which were in countries holding elections for the first time. Young democracies are not immune to the electoral cycle. Before Ghana's 1992 elections, the government increased outlays and the wage bill at the cost of macroeconomic stability and subsequent inflation. In Sub-Saharan Africa the numbers of ministerial positions and legislative seats have increased by 22 percent during the political transition that began in 1989. The governments of Cameroon, Malawi, and Senegal all have more than thirty ministers each. A careful prioritization of policy issues is difficult to achieve in such an atmosphere. Bolivia, for instance, has responded by putting legal restrictions on the size of the cabinet: only two additional ministries may be created, and those on a temporary basis. These experiences suggest that states need skill to manage the political transition in such a way that it does not impede the development agenda.

When and why do countries reform?

Insights about the circumstances under which reforms are likely to succeed are as useful as insights about the obstacles to reform. Indeed, the two are related. If circumstances are conducive to reform, the first step is to alter the dynamics that created the status quo. The following sections describe how an external threat or an economic crisis—real or perceived—may override resistance to change. They may. But they have not always done so. It remains a puzzle why some countries reform in such extreme circumstances and others do not.

External threat

A growing external military threat has often triggered reform. Until recently, a country's lagging technological and economic performance became evident only during wartime. In the 1700s and 1800s the leadership of the Ottoman Empire reorganized the military and made broad reforms in education and governance, in response to battlefield losses to European powers. Similarly, the Meiji restoration in Japan in 1868 was motivated by a desire to strengthen the state against the encroachments of Western powers (Box 9.3).

Today, military confrontation plays a smaller role in driving reform. But the perception that a country is lagging behind its neighbors economically often leads to important demonstration effects. Chile's economic success clearly inspired other Latin American countries to undertake reform in the late 1980s, as did the success of Japan and, later, that of the Republic of Korea and Taiwan (China) in East and Southeast Asia. Economic reform in China can be explained by many factors. But among them was the demonstration effect of its neighbors' economic success and an unwillingness to be left behind.

Box 9.3 Reform under external threat: The Meiji restoration in Japan

The intrusion of Western powers into national commerce was the impetus for reform in Japan. Starting in the 1840s, Japan was under increasing pressure from the West to grant commercial and trade privileges. The Tokugawa leadership was aware that Japan's technological and military prowess lagged, and in 1854 Japan had little choice but to accede to Commodore Perry's demand that some ports be opened to American ships. Similar arrangements with other foreign governments followed. By 1865 Western powers had restricted Japan's ability to levy import tariffs: the highest rate was set at 5 percent. In 1868 a coalition of feudal lords overthrew the Tokugawa family, which had ruled Japan for more than two centuries, and replaced it with a leadership that would modernize Japan and transform it into a country better able to face up to foreign threat. This so-called Meiji restoration marked the beginning of modern Japan's economic growth.

Reforms following the restoration transformed the Japanese state and society. The class system was abolished, a new system of local and national government was set up, and conscription into the army and the navy was instituted. To establish the basis for a sound fiscal system, the government undertook a land survey, established titles, and implemented a land tax payable in cash. Education was gradually made compulsory, so that by the mid-1880s almost half of school-age children were attending school. The Bank of Japan (the central bank) was created, and bureaucratic reforms were undertaken, laying the ground for the recruitment of state officials based on merit, not patronage. Moreover, the new regime undertook initiatives that today would be called industrial policies: it established and operated factories (silk, brick, glass, cement, textiles, shipyards), subsidized industries, imported technicians, and sent students abroad.

Economic crisis

Since the early 1980s, economic crisis has been by far the most important factor driving the introduction of ambitious reforms. As the failure of prevailing policies becomes widely recognized, popular demands for reform become more vocal, and politicians more willing to risk radical change. Economic crisis—particularly hyperinflation and deep recession—preceded economic reform in, for example, Indonesia in 1961–64 and Peru in 1990. Yet other countries in dire economic straits have failed to take corrective measures, while several countries have not needed a deep crisis to spur reform. Economic crisis cannot be credited with stimulating reform in Australia (1983), Colombia (1989), or Portugal (1985).

Economic crisis and civil conflict often feed on one another, leading to near disintegration of the state (for example, in Liberia and Somalia). Such crises have immense social costs and offer little hope for quick resolution, for state capability matters when it comes to turning a crisis into an opportunity. Yet political leadership and political entrepreneurship are also important. And often political leaders who can convert opportunities for economic gain into reality can capitalize on the benefits of successful reform.

Even in time of crisis, incumbents are often more reluctant to embrace reform than are newcomers. Thus, a change in government in the middle of an economic crisis (as in Peru and Poland in 1990) may provide the added impetus needed to get reform started. Terrorism, hyperinflation, and the poor performance of traditional parties in Peru all gave the new president, Alberto Fujimori, room to maneuver. On the other hand, Colombia's reforms took place in 1989, toward the end of the administration of Virgilio Barco, when the economy was not in crisis. So honeymoon periods and economic crisis provide an opportunity, but not the only opportunity, for embarking on reform. More important, even in countries where economic crisis has triggered reform, the depth of reform has tended to be modest. Lasting improvements in economic performance have often remained elusive. Economic crisis may provide an opportunity to go beyond stabilization, but whether or not countries seize the opportunity depends on the redistributive effects, the state's initial capability, and political leadership. Deep institutional reforms are unlikely to result from a reform agenda triggered and driven by crisis alone.

Implementing and sustaining reform

Reform of the state means not only reform of policies but also an institutionalization of good rules of behavior for government agencies. Institutions must be created that help avoid heavy discounting of the benefits from reforms, paralysis due to unfamiliar new circumstances, and problems of social mistrust. A balance must be struck between clear rules that circumscribe the freedom of state officials to act opportunistically, and the need for them to act flexibly and responsively. An effective state operates with clear and transparent rules, yet is quick to exploit opportunities and to reverse course when circumstances demand it.

The obstacles to building an effective state are not insurmountable. Change has a better chance of success when policymakers do three things: tactically design and sequence reforms, compensate losers, and build consensus. We take up each of these in the following discussion. But in some cases institutions must be modified to make the state function better: it is no longer a question of tactics but of fundamental reform. One lesson is clear: all these changes are a good deal more difficult—impossible, even—in the absence of leaders with a clear vision of the future.

Tactical design and sequencing

Tactical design and sequencing of reform can improve the chances of success by recognizing the constraints of existing state capabilities, diluting resistance to change, and building a constituency in favor of reform.

MATCHING ROLE TO CAPABILITY. As emphasized throughout this Report, a good match between the state's role and its capability is the key to effective policies. A mismatch between capability and action can compromise the sustainability and effectiveness of reforms even in the absence of political obstacles. Regulatory reform—whether of antitrust, environmental, or financial regulation—should reflect institutional capabilities (see Table 4.2). For instance, price-cap regulation, in which the regulator sets the adjustment factor used in determining a monopoly utility's prices, is more suited to countries with relatively strong institutions. Similarly, mechanisms to improve the delivery of services have to take into account not only the characteristics of the service but also the capability of the state (see Table 5.1). Within the core public sector (in education and health care, for example), using performance-based agencies and formal contracts requires an institutional capability that many developing countries lack. In these cases such institution-heavy approaches are unworkable. Capability constraints should also loom large in the choice of a decentralization strategy (see Table 7.5). Where capability is low in both central and local government, a cautious decentralization strategy with pilot testing is probably the best course. But, as Part Three of this Report showed, capability is not destiny. And the return to improving capability is significant indeed.

STRATEGIC SEQUENCING AS A FIRST STEP TO IMPROVING CAPABILITY. Where administrative capability is weak, rather than attempt comprehensive reforms of all institutions, countries might do better to reform key functions and agencies selectively. Besides being consistent with fiscal and human resource constraints, this approach has two advantages. First, it allows reformers to learn from the unavoidable mistakes associated with institution building. Second, by beginning with the most promising agencies, reformers can count on demonstration effects for the rest of the public sector. These two advantages increase the likelihood of achieving a series of success stories that will maintain political support of an overall reform program.

Many countries have used this strategic approach, beginning reform with a few critical enclaves. Candidates for early treatment typically include the ministry of finance, the central bank, and the tax collection agency. In both Peru and Ghana, for example, very low tax revenues forced the government to make swift changes in tax collection. Yet any country following such a strategy must ensure that the assignment of policy responsibilities among agencies and ministries takes into account where the relevant professional expertise is concentrated, and that mandates are broadly consonant with the public interest at large. For instance, a tariff regime that is managed out of the finance ministry is likely to emphasize revenue goals over industry protection—the priorities would probably be reversed if the ministry of commerce were in charge. Transforming quantitative restrictions into tariffs would typically receive more support from the treasury (see Table 9.1). The appropriate assignment of policy responsibilities can help sustain reform by influencing what gets approved and in what order.

The strategic enclave approach allows countries to adopt the first generation of reforms (Table 9.3). These reforms—which can mostly be enacted through executive order—typically involve stabilization and selected structural reforms. But an excessively narrow approach to enclaving can impede the deeper institutional changes required by the second generation of reforms. And progress in the social sectors has generally been modest. For example, in Ghana, one of the pioneer reformers in Sub-Saharan Africa, health expenditures have become even more regressive since reforms began. Deep institutional reforms take time and are complex, and opposition by interest groups (for example, the teachers union in Colombia) is often strong. For countries trapped in the first generation of reforms, sustainable long-term development will be elusive.

Countries can implement a strategy that enables them to escape the enclave trap. Such a strategy involves, above all, agreeing on clear rules for the conditions under which agencies outside the original enclave will be brought within the reform program. These rules provide a bridge between the first- and second-generation reforms, while mitigating animosities from agencies outside the enclave. The Bolivian civil service reform has rightly moved in that direction. Embedded in the 1990 Financial Administration Act and associated agency-specific regulations are a series of rules governing which entities are eligible to recruit highly paid civil servants, what conditions these entities have to meet in order to qualify, and what is expected from them once they have implemented the

Table 9.3 First- and second-generation reforms

	First generation	Second generation
Main objectives	Crisis management: reducing inflation and restoring growth	Improving social conditions and competitiveness, maintaining macroeconomic stability
Instruments	Drastic budget cuts, tax reform, price liberalization, trade and foreign investment liberalization, deregulation, social funds autonomous contracting agencies, some privatization	Civil service reform, labor reform, restructuring of social ministries, judicial reform, modernizing of the legislature, upgrading of regulatory capacity, improved tax collection, large-scale privatization, restructuring of central-local government relationships
Actors	Presidency, economic cabinet, central bank, multilateral financial institutions, private financial groups, foreign portfolio investors	Presidency and cabinet, legislature, civil service judiciary, unions, political parties, media, state and local governments, private sector, multilateral financial institutions
Main challenge	Macroeconomic management by an insulated technocratic elite	Institutional development highly dependent on middle management in the public sector

Source: Adapted from Naim 1995.

reform. Yet Ecuador's experience with a similar reform strategy illustrates that it requires a firm commitment to the program to ensure that these rules are implemented in practice. Two months after finalizing the rules governing administrative reform, the secretary in charge declared all central administration entities "restructured" and granted salary enhancement, although none had met the eligibility conditions. Rules can underpin a commitment to reform—but they cannot substitute for it.

GRADUAL PHASING OUT. Matching the state's role to its capability and going beyond enclaving sometimes require replacing a public agency with a private one. This, in turn, may call for a two-stage strategy to circumvent resistance. During the first phase, an opting-out mechanism might be put in place, to allow people to switch to private providers if they want to. Wider recognition of the benefits of better services can then make it easier to carry out the second phase: getting rid of the public providers.

Sri Lanka's 1991 Telecommunications Act shows the benefits of such a strategy. This act created the regulatory agency and allowed private operators to compete with the state monopoly Sri Lanka Telecom (SLT) in value added telecommunication services. The legal and regulatory framework has contributed to making Sri Lanka one of the most liberalized telecommunications markets in Asia. By 1995 there were four mobile cellular operators, five paging companies, three data transmission service providers, and one Internet provider. At the end of 1995, 20 percent of all telephone subscribers were connected to cellular services. Competition between the cellular operators has led to some of the lowest tariffs in the region, and these services are increasingly seen as a credible alternative to SLT's wired services. To reduce unsatisfied demand quickly, in early 1996 the telecommunications regulatory agency licensed two fixed wireless private operators for basic telecommunications services. These impressive results have created pressure for better performance by the public telecommunications company. Consistent with a two-stage phasing-out strategy, the government has announced the sale of 34 percent of SLT's equity to a strategic investor.

Peru's pension reform illustrates how gradual phasing out can be applied to the social sectors as well. When the reform was launched in 1993, workers were allowed to choose between public and private pension providers. In 1996 disincentives for joining a private provider were removed, leading to a de facto phasing out of the public scheme. During the second stage a strong constituency in favor of the reform was formed, comprising workers who had already shifted to a private provider and pension fund managers. By contrast, the sequencing of Pakistan's direct tax reform seems to have greatly reduced the chances of success. The government began the reform with a reduction in rates, which was supposed to be accompanied by a removal of tax holidays. But the powerful agricultural lobby blocked the lifting of exemptions, and an attempt in 1993 to introduce a tax on rich farmers was circumvented by raising the exemption ceiling tenfold. By contrast, even a revenue-neutral tax rate reduction combined with a broadening of the tax base would have cut distortions without creating losers. A back-of-the-envelope estimate of the benefit of reduced distortions suggests it would be upward of 1.4 percent of GDP (see the Technical Note).

EFFICIENCY VERSUS TACTICAL SEQUENCING. The optimal sequencing from an efficiency standpoint may not be politically feasible. For example, efficiency considerations dictate setting up a credible and stable regulatory agency before privatizing telecommunications. This sequencing reduces the risk involved in the purchase, hence increasing the selling price of the company. Argentina, however, did not follow this sequence. Instead the country's telephone monopoly was sold a year before a new regulatory agency was set up. This strategy was adopted to speed privatization and prevent opposition to the reform. Regulatory uncertainty may have reduced the selling price, but the political feasibility of the reform was greatly enhanced. And as noted above, the efficiency gains induced by the overall privatization program were significant (Table 9.2). Moreover, countries choosing for political reasons to reverse the most efficient sequencing might mitigate the disadvantages of the lower initial selling price by selling shares in stages, as the reform's credibility improves.

COMBINING AND PACKAGING REFORMS. Introducing the right mix of reforms could allow key constituencies to balance their gains and losses, hence reducing the political cost of the reform (see Box 9.1). This strategy was pursued by New Zealand's Labour government in the 1980s. Minister of Finance Roger Douglas persuaded agricultural groups that losing their subsidies was essential to the total reform package, which benefited farmers by cutting tariffs, lowering inflation, and addressing the bias against exports. Similarly, in Bolivia the broad reform package introduced in 1985 by the government of Victor Paz Estenssoro, in a context of hyperinflation, managed to circumvent labor opposition, which had vetoed previous reform plans. Although support from the two main political parties helped, the speed and comprehensiveness of the reform prevented pressure groups from organizing to derail it.

When deep macroeconomic imbalances have to be corrected, packaging some reforms could increase their political feasibility. For example, trade liberalization is often easier to implement in conjunction with an adjustment program, because the gains from improved macroeconomic policy (in lower inflation and positive growth) can offset the distributive effects of liberalization (see Box

9.1). Broad reforms may also enhance credibility. In 1990 the Polish government freed 90 percent of prices, eliminated most trade barriers, abolished state trading monopolies, and made its currency convertible for current account transactions. After an initial decline in output in 1990–91, the Polish economy has recorded vigorous growth.

Compensation

SEVERANCE PACKAGES. Both matching the state's role to its capability and enhancing its capability require not only tactical design and sequencing but also the compensation of groups adversely affected by reform, to secure their support. These groups are not always the poorest in society. They may, for example, include bureaucrats whose jobs are being eliminated, managers of privatized state enterprises, and businesspeople used to operating behind high levels of trade protection. Although compensation might be economically costly in the short run, it will pay off in the long run to the extent that it eases opposition to reform. A recent study of retrenchment programs found that, on average, the associated benefits in terms of productivity gains and wage bill savings offset the compensation cost after only 1.7 years. Three factors show why severance payments can be so important to the success of reform. First, political feasibility may require that retrenchment be done on a voluntary basis. Second, even where political constraints are not a factor, the law may preclude involuntary separation, as in the case of the Central Bank of Ecuador. Third, most developing countries do not have an unemployment insurance scheme, and severance pay then becomes a close substitute.

Designing severance schemes that take into account broader characteristics of workers can help make politically feasible retrenchment less costly and better targeted. One such mechanism is to set ceilings on the number of departures by skill level. In Argentina, for instance, trained professionals from the National Institute of Agricultural Technology were made ineligible for voluntary retirement packages. It is also important when designing retrenchment programs to establish built-in mechanisms that prevent rehiring, which would defeat the purpose.

EQUITY INCENTIVES. In some cases compensation goes beyond generous severance payments: labor, management, or the public at large may be given a share of privatized enterprises. Bolivia's capitalization program is a very innovative approach. At least three features of the program increased its political acceptance without compromising on efficiency gains:

- By distributing shares to employees and pensioners, the program circumvented the resistance to privatization that often occurs when assets are sold entirely to foreign companies.
- Tangible benefits accrue to citizens early in the process. Beginning in May 1997 each person over 65 will get an annuity from the capitalization program with an estimated value of $200 to $225. Bolivia's income per capita, for comparison, was $770 in 1994.
- A concern often raised by opponents of privatization, namely, that it provides an opportunity for corruption, is somewhat mitigated (whether warranted or not) because the state does not receive funds.

The Bolivian and Czech experiences show how a carefully designed privatization program can enhance political feasibility and achieve sustainable efficiency gains, but poorly designed versions of these strategies can backfire.

Building consensus

Reforming the state requires cooperation from all major groups in society. Deep-seated differences and mutual suspicions among groups can delay or kill reform. There are no quick fixes for reversing age-old enmities, but social pacts can help. In a social pact, business, labor, and agricultural interests negotiate the terms of a contract with government leaders, setting clearly defined responsibilities for each group. This approach has proved successful in countries as diverse as Spain and Benin. In Spain a minority government was able to impose wage restraint by bringing all political parties to the negotiating table and developing a common program, later known as the Moncloa Pacts (Box 9.4). Benin's second democratically elected government organized a consultation with political parties and civil society on taking office in May 1996. This National Economic Conference created a number of sectoral working groups and made specific recommendations about the role of the state. Whether this initiative will translate into a consensus around an economic program remains to be seen.

Leadership and vision

There is no universal blueprint for reform. But almost all successful reform episodes in developing economies have had one common feature: they have been crafted by dynamic leaders who shepherded changes through complicated political terrain. Such leaders seize opportunities as they appear, but they also create them, by identifying and reaching out to potential beneficiaries, reshaping institutions, and articulating a compelling and achievable vision for the future. Political leadership is particularly important in countries that lack trust and cohesion among different social groups. When businesspeople mistrust bureaucrats, workers are wary of managers, and farmers are suspicious of everyone, sensible reforms can stall. Leaders must instill a sense of common purpose that minimizes polarization.

Box 9.4 The Moncloa Pacts in Spain

Adolfo Suarez was named chief of government by Spain's King Juan Carlos I in July 1976, early in the transition to democracy following Generalissimo Francisco Franco's death in November 1975. Suarez started by instituting political reforms: he recognized free trade unions and the right to strike, legalized all political parties (including the Communist Party), proclaimed a political amnesty, and passed a new electoral law. The first free elections since the Spanish civil war were held on June 15, 1977. Suarez won the elections, but his newly created party, the Center Democratic Union, held only 47 percent of the seats in parliament.

The elections took place as the economy was falling into a crisis. Inflation and unemployment were both on the rise, and the external balance was deteriorating rapidly. As part of its anti-inflationary drive and its policy of external liberalization the Suarez government sought to reduce wage growth. But rather than confront the labor movement and the trade unions, Suárez took a consensual approach to incomes policy. Peak business and labor associations were brought together in late summer 1977 to forge a common position. These attempts failed, however, because of deep divisions within business and labor. Labor, for example, was represented by officials from at least four distinct political leanings. No one wanted to appear to be making concessions.

Suarez then changed strategy and sought agreement among party rather than class leaders. The resulting agreements, reached in October 1977, have come to be called the Moncloa Pacts. Agreement among the political parties proved easier to achieve because the party leaders were more moderate than the interest groups they represented, and because the far left (which had no parliamentary representation) could be excluded.

The pacts went far beyond wage restraint and encompassed provisions on monetary and fiscal policies and structural reforms as well. They promised a "new framework for labor relations" with increased labor market flexibility, a more progressive tax system, and the rationalization and decentralization of public enterprises. Importantly, the pacts contained measures to compensate workers for some of the costs that adjustment was expected to impose on them. Increased state spending on job creation and unemployment insurance, the progressive extension of unemployment insurance to all the unemployed, and some price controls were among the compensatory measures. Given that Spain already had the highest level of worker conflict in all of Europe, getting labor to go along with fundamental reforms without these concessions was a major achievement.

Although not all the promises made in the Moncloa Pacts (especially those in the areas of labor market reform and public enterprises) were fulfilled, the pacts were successful in achieving their primary targets. Price and wage inflation was sharply reduced after 1977, and the current account gap was closed.

The purpose of reform is to enhance economic well-being. The consequences of reform are often measured using quantifiable yardsticks, such as national income, exports, or inflation. But an equally important aspect of reform is whether it succeeds in reshaping the values and norms of the state and the state's relationship to the economy. It is this transformation that ultimately legitimates reforms in the public eye. Thus political leaders must offer a compelling vision, beyond the dry realities of economic efficiency, about where their societies are headed. Such a vision can motivate and rally support for reforms.

For example, in some transition economies—such as the Czech Republic, Hungary, and Poland—reform was aided by the prospect of joining the European Union. The same desire motivated reform in Spain and Portugal in the early 1980s. In other instances a clear vision does not present itself so easily. Venezuela's reforms under Carlos Andrés Pérez were a political failure because there was no coherent vision to help sell the reforms (Box 9.5). In Malaysia, by contrast, Prime Minister Mahathir Mohamad's policy initiatives in the 1990s were packaged in his Vision 2020, which set the eye-catching target of raising Malaysian living standards to industrial-country levels by 2020.

Strategic options: Finding the route to reform

Machiavelli rightly recognized that distributional conflicts lie at the heart of the difficulties of reforming the state. Yet such conflicts, and the constraints embedded in state institutions which can exacerbate them, are not immutable. Change will come when the incentives to throw out the old policies and institutional arrangements become stronger than the incentives to keep them. An economic crisis or an external threat may provide the impetus for initiating reforms. But its precise timing can be prolonged if those who control state power stick with outdated policies because it is in their (or their allies') interest that it be so. Sometimes the delays can be painfully long, as in Haiti under the Duvaliers or Zaire today.

Box 9.5 Venezuela's 1989 reform program and its reversal

In the late 1980s the Venezuelan economy was experiencing a deep crisis, with internal and external imbalances generated by an overextended state and a mismanaged economy. In 1989 Carlos Andres Perez, who had served as president in the 1970s, was reelected. His 1989 stabilization plan included a sharp devaluation of the bolivar and a lifting of price and interest rate controls. The plan restored internal and external balance and was accompanied by structural reforms such as trade liberalization, privatization, and increased central bank autonomy.

These reforms were made possible by the broad executive powers of the Venezuelan presidency. But the consensus on them did not last long. After a period of political instability, in February 1994 Rafael Caldera was elected as leader of a coalition government. The new government started by repudiating some of the reforms, eliminating the value added tax and returning to price and interest rate controls. The autonomy of the central bank was also compromised, prompting its president to resign. Constrained by international agreements, the administration did not reverse trade liberalization, but instead relied on nontariff protection. The program's lack of coherence caused an erosion of confidence in the international investment community. Venezuela's bond rating dropped 20 percentage points below its 1991 level. In 1994 real GDP dropped by 3 percent, and inflation soared to 71 percent. In the second quarter of 1996 the administration began adopting more orthodox economic policies, supported by an arrangement with the IMF. These have been implemented with some success thus far. How far-reaching and sustainable this program will be remains to be seen.

Venezuela's experience highlights some important points about the sustainability of reform. Economic reform is more susceptible to reversal when it is supported by only a few technocrats, without backing from political parties or other groups. Reforms linked to stabilization are easier to implement than are structural reforms requiring congressional approval. Moreover, economic reforms are harder to implement in an environment prone to political risk. Introducing new taxes is contentious in an environment where state control over natural resources (in this case petroleum) gives the appearance of cost-free public services. A crisis may be sufficient to create the conditions for initiating reforms, but sustaining them requires much more. Long-term performance requires vision and unity of purpose.

This chapter has shown how windows of opportunity can open, and how important it is to seize these opportunities to bring about change—through compensation of potential losers, the skillful choice of tactics, and building consensus. As emphasized throughout this Report, it is important to reckon on state capability when designing reforms. But reformers cannot afford to stop there: they must also have a strategy for improving capability. A more capable state can broaden the scope of policy options and significantly improve economic performance. Strategic sequencing, and even well-thought-out enclaving, are a good first step and are consistent with the budgetary and other constraints facing many developing countries. Early on, however, countries should design a strategy for going beyond reforming a few agencies, and thus escaping the enclave trap. This involves defining clear rules under which agencies outside the original enclave will be brought into the reform program. Rules and tactics, however, are no substitute for commitment and political leadership.

Leadership is not everything: even committed and visionary leaders are not always able to throw off the heavy legacy of years, perhaps decades, of poor performance. Choosing reform in these circumstances usually involves a leap of faith, a leap that can be as frightening to those who will ultimately gain as it is to the losers. In these circumstances the presence of someone who can convince the public that the leap is worth making is a potent reform weapon indeed.