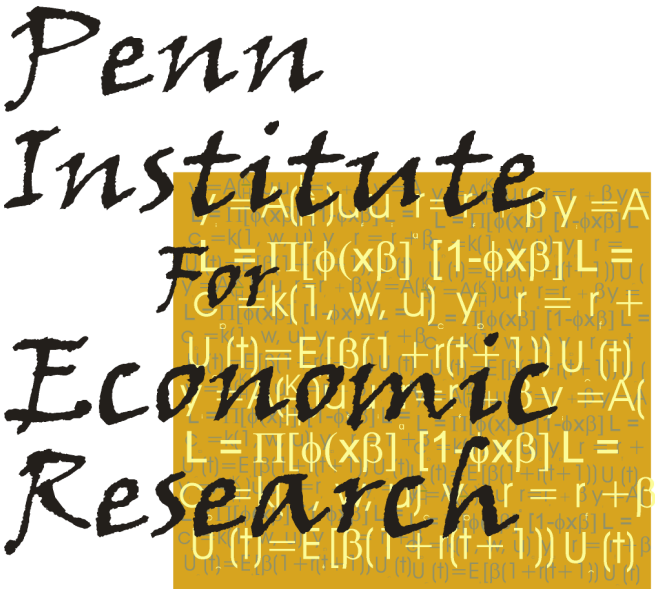

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PIER Working Paper 97-013

"Policy Conditionality"

by

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*Policy Conditionality**

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July 1996

Abstract

If policy makers in developing countries pursue "bad" economic policies, policy conditionality may provide financial leverage which induces them not to choose these policies. When is such policy conditionality beneficial? We point out that whether conditionality has a beneficial short run impact depends critically on the political economy explanations of the particular "bad" economic policy in question. We also argue that conditionality can only have a long-run impact if there is a tendency for reforms to "persist" and discuss alternative explanations for policy persistence.

*We are grateful for funding for this research from the World Bank under RPO 680-18, "Analytical Perspectives on Aid Effectiveness in Africa."

> It makes considerable sense for the World Bank and other multilateral agencies to push very hard for liberal policies in developing countries, given the demonstrated tendencies of these clients to engage in economically irrational interventions (Krugman (1992), page 32).

1. Introduction

The World Bank carries out extensive *policy conditionality*: developing country policy makers agree to a program of economic policy reform in exchange for grants and concessionary finance. There are two ways in which policy conditionality might have a beneficial impact. First, policy conditionality may have a *short term* impact: during the lifetime of policy conditionality, the promise of resources induces policy makers to make beneficial policy changes. Second, policy conditionality may have a *long term* impact: the short term implementation of beneficial reforms may alter the political environment in a way that favors the continuation of those policies. In this paper, we discuss the circumstances under which policy conditionality can have beneficial impacts in the short and long run.

We argue that to analyze the short term effects of policy conditionality, it is necessary to understand *why* policy makers are choosing the economic policies that the World Bank is trying to reform. Often "economically irrational interventions" (see the above quote) are politically rational and favor interest groups that policy makers wish to favor. Banning the economically irrational interventions may induce policy makers to make transfers to those special interests in more costly ways which cannot be controlled by policy conditionality. In this way, policy conditionality can make all citizens in the recipient country worse off, having an unambiguously negative impact. We discuss the conditions under which this negative unintended consequence of conditionality is likely to arise.

With respect to its long run effects, we argue that conditionality will only have an impact if there is a tendency for reforms to *persist*. Thus, it is necessary to understand *why* short term implementation of reform policies will alter the political environment in favor of those policies. Without understanding policy persistence, there cannot be much hope of predicting when policy conditionality will have a long term impact. We discuss some different explanations for policy persistence, and examine their implications for the long run impact of policy conditionality.

Many authors within and outside the World Bank have conducted theoretical and empirical analyses of policy conditionality (see Haggard and Webb (1995), Mosley, Harrigan and Toye (1991), Svensson (1995) and World Bank (1988)). Our methodological contribution in this paper is to base all our analysis on explicit theories of public choice. We believe that it cannot make sense to employ policy conditionality without a theory of why policy makers in developing countries choose the policies they choose.[1]

The remainder of the paper is organized as follows. Section 2 discusses the short run impact of conditionality, showing how its welfare consequences depend on the underlying political and policy environment. Section 3 focuses on the long run impact of conditionality, discussing alternative explanations for policy persistence and their implications for conditionality. Section 4 concludes with a summary of some of the general lessons which emerge from the analysis.

2. The Short Term Impact of Policy Conditionality

We will frame our discussion in terms of the following simple example. A developing country policy maker is supporting a domestic cement industry by protecting local producers from international competition. This policy is serving no useful economic objective (encouraging learning by doing, for example), its only role being to make transfers from the population at large (who ultimately consume cement) to the domestic cement industry. In addition, there are significant *deadweight costs* associated with the transfer; that is, the gains from the policy for the cement industry will be less than the cost to the rest of the economy. The World Bank has no desire for transfers to be made to the cement industry, and would like to induce the policy-maker to eliminate the protection. The World Bank is considering offering grants, loans etc to the country, which would be to the policy-maker's benefit. Should it make the granting of this financial package conditional on the removal of this protection? Or would such conditionality make matters worse?

[1] In the introduction to Haggard and Webb (1995), Summers describes various political problems in economic policy making but argues that "...research on political economy does not need to describe in more detail how the mechanisms of these challenges operate. Rather, the task is to find politically acceptable ways of designing institutions to minimize these problems." We believe, on the contrary, that in designing such institutions in general and policy conditionality in particular, it *is* necessary to be explicit about the political motivation for economic policies.

In this section we show that the answer depends on why the policy maker does not want to eliminate the protection. (If he favored reform, he would presumably implement it unilaterally and there would be no role for conditionality). In much of the discussion of policy conditionality, the implicit assumption is that the policy maker chooses bad policies merely because he does not know any better. For example, perhaps he believes (wrongly) that there is learning by doing in the cement industry so that protection will encourage dynamic economies of scale and create positive externalities in the economy as whole. In this case, he just needs to be shown that the economy would be better off without the policy and policy conditionality is a convenient way to convey this message. Policy conditionality is therefore obviously beneficial.

Suppose, however, that the policy maker is perfectly aware of the effects of the policy and is against eliminating it because he wishes to redistribute to the cement industry. There are many reasons why politicians, in both democratic and authoritarian regimes, wish to make transfers to special interests such as the cement industry. They may expect *political* favors in return, such as votes or financial support for their political movement. They may expect (or negotiate) *personal* favors in return, such as bribes or future employment. The cement industry may be located in a region which the policy maker wishes to favor, either for the above reasons or because he is a benevolent ruler who believes that increasing wealth in that region is necessary to maintain peace. For our purposes, the reason why the politician favors transfers to the cement industry does not matter. What is important is that we must consider how he will respond if this method of redistribution is removed via conditionality. Here we consider this question under two different hypotheses. The first, the *efficient transfers* hypothesis, is that the policy maker favors protection because it is the most efficient way of redistributing to the cement industry. The second, the *hidden transfers* hypothesis, is that the policy maker favors protection because it allows him to hide the fact that he is making transfers to the cement industry.

2.1. Efficient Transfers

We are assuming that the policy maker is against eliminating protection because he wishes to redistribute to the cement industry. However, this is not a *sufficient* explanation of why the policy maker favors protection. Presumably the policy maker could have transferred resources to the cement industry in many different

ways, for example, by offering production subsidies, government purchases of cement at inflated prices, etc.. If the cement industry was favored because of its geographical location, the policy maker could have offered the region new schools, new hospitals, new roads, or more government jobs. From all these possible options, the policy maker chose protection as the transfer mechanism. It is reasonable to assume that this was the *cheapest* method available of making transfers. The Chicago School of Political Economy has long argued that in a democratic environment, transfers will be made in efficient ways: after all, if transfers were being made inefficiently, all voters would have common interest in voting out the policy maker (see Stigler (1982), Becker (1985) and Wittman (1989)). One might expect that similar pressures would be at work in a non-democratic environment: rational policy makers can only gain by making transfers in the cheapest possible way.

This way of thinking is important because it forces one to consider *the equilibrium effects of policy conditionality on the choice of transfer mechanism.* In particular, if the World Bank provides an incentive to the policy-maker to remove the protection program, then is it not possible that the policy-maker will simply choose an alternative, less efficient transfer mechanism. If so, is it not possible that such conditionality might make all parties worse off?

To shed light on this consider the following simple model. There are two groups in society: the cement industry and regular citizens; their income is represented by y_c and y_r respectively. The policy maker has smooth, strictly convex preferences over y_c and y_r represented by $u(y_c, y_r)$. This utility function is a reduced form for some more complex political process. Write $x_i^*(p, y)$ for the value of y_i maximizing $u(y_c, y_r)$ subject to $y_r + py_c \leq y$. Both y_c and y_r are normal goods in the policy maker's utility function, so that $dx_i^*/dy > 0$ for each $i \in \{c, r\}$. The World Bank cares only about y_r (the analysis which follows would generalize as long as the policy maker cares more about transfers to the special interest than the World Bank). Suppose for simplicity that the citizens initially have income y_r^0 while the cement industry has zero income.

To establish a benchmark, let us begin by supposing that the policy-maker has only one way of making transfers to the cement industry: protection. This policy has net benefits B for the cement industry and net costs C for the citizens. Assume that $B < C$ so that there is a deadweight cost of protection. The policy

maker would choose to implement (or maintain) protection if

$$u\left(B, y_r^0 - C\right) > u\left(0, y_r^0\right)$$

Assume this condition were true, what could the external agency do to prevent implementation of the policy? A World Bank policy reform package would consist of a payment G that would be made only if protection were removed. The minimum payment necessary, G^*, is implicitly defined by:

$$u\left(B, y_r^0 - C\right) = u\left(0, y_r^0 + G^*\right)$$

Each though the policy maker cares more about the cement industry than regular citizens, there is some minimum payment that will induce the policy maker not to carry out protection. If the World Bank promises G^* if the policy is not implemented, notice that not only does the citizen not incur the costs of protection, C, but also the citizen will receive the World Bank assistance, G^* (we are assuming that the World Bank assistance benefits the citizen, not the politician directly). The payment of G^* has the effect of increasing the citizen's income by $C + G^*$ (from $y_r^0 - C$ to $y_r^0 + G^*$). In this sense, policy conditionality works and has a multiplier effect.

Now suppose that the policy maker also has the ability to make cash transfers from regular citizens to the cement industry. Specifically, the policy maker can give T to the special interest by taking away $(1+\delta)T$ from the citizen. From a technological point of view, how do cash transfers compare with protection? Notice that the cash transfer mechanism can be used to give B to the special interest at a cost of $(1+\delta)B$; so we say that the policy is an *efficient transfer mechanism* if $C < (1+\delta)B$, i.e. $B/C > \frac{1}{1+\delta}$.

Let us first analyze what would happen if there was no policy conditionality and protection was *not* available. In this case, the policy maker would choose transfer level $T^* = x_s^*(1+\delta, y_r^0)$. Suppose now that the protection were made available, with $B < T^*$. If protection is not an efficient transfer mechanism, the policy maker will not implement it and will choose transfer level T^*. If protection is efficient, the policy maker will implement it and choose transfer level $T^{**} = x_c^*(1+\delta, y_r^0 + (1+\delta)B - C) - B$. The income of the cement industry is then $x_c^*(1+\delta, y_r^0 + (1+\delta)B - C)$ while the income of regular citizens is $x_r^*(1+\delta, y_r^0 + (1+\delta)B - C)$. If protection is used, it must be efficient and both groups' incomes are higher that if the policy were not implemented. The effect of

allowing the cheaper transfer mechanism is to strictly increase the size of the set of income pairs (y_c, y_r) feasible for the policy maker. Now our assumption that citizen and special interest income are both "normal goods" in the policy maker's preferences implies that both are better off.

Let us now analyze policy conditionality. If we allowed financial payments to be made contingent on *both* whether protection were removed *and* the level of cash transfers, the qualitative conclusions would be much as before. But a major practical problem for World Bank policy conditionality is that there are a limited number of actions which can be effectively monitored and thus used as conditions in reform programs. In practise, there will always exist an array of policies (not necessarily with any *budgetary* implications) which have the effect of increasing the utility of one group at the expense of another. Thus we want to consider the case where financial payments are made contingent on whether protection is removed *but not on the level of cash transfers.*

Let us again assume that the World Bank offers a payment G if protection is not implemented. If the policy maker chooses to accept the reform package, the policy maker will not implement protection but will then choose an optimal level of transfers, $T^*(G) = x_c^*(1+\delta, y_r^0 + G)$. If the policy maker refuses the reform package, the policy maker will implement the policy and again choose an optimal level of transfers, $T^{**} = x_c^*(1+\delta, y_r^0 + (1+\delta)B - C) - B$. Thus the minimum cash payment G^* necessary to induce the policy maker not to implement the policy is implicitly defined by:

$$u\left(T^*(G^*), y_r^0 + G^* - (1+\delta)T^*(G^*)\right) = u\left(B + T^{**}, y_r^0 - C - T^{**}\right)$$

The citizen's income in this case is $x_r^*(1+\delta, y_r^0 + G^*)$. But suppose that the World Bank had instead provided G^* to the developing country with no strings attached. In this case, the policy maker would implement the policy and choose cash transfer $x_c^*(1+\delta, y_r^0 + G^* + (1+\delta)B - C) - B$. The citizen's income in this case is $x_r^*(1+\delta, y_r^0 + G^* + (1+\delta)B - C)$. The normality of preferences ensures that the citizen would be better off under this scenario than if the policy maker was induced not to implement the project. In this case, therefore, conditionality makes all agents worse off and is unambiguously a bad idea.

The two cases considered so far were somewhat extreme. If protection is the only transfer mechanism, or more generally if the World Bank program can monitor all possible transfer mechanisms, then policy conditionality may work well in preventing transfers. If, on the other hand, protection is not the only transfer

mechanism and banning the policy does not alter the marginal deadweight cost of transfers, then the only effect of banning the policy is to increase the equilibrium cost of transfers. An intermediate case is one where the World Bank cannot monitor all transfer mechanisms (so an outright ban is impossible) but it can outlaw some methods in such a way that the marginal deadweight cost of transfers increases. The question is then whether increasing the marginal deadweight cost of transfers benefits the citizens or not in equilibrium.

This issue closely parallels one studied by the Virginia School of Political Economy (Brennan and Buchanan (1980), pages 4/5). Should constitutions allow governments to intervene extensively in the economy? Assuming the government interventions are intended merely as transfer mechanisms, the answer depends on a trade-off. Banning certain interventions merely increases the cost of making transfers, assuming it is not possible to ban all interventions. This implies a relative price effect: less transfers will be made because of the higher price. But it also implies a loss of real income, which will tend to reduce the welfare of both winners and losers from the transfer. Thus the overall effect will depend on elasticities (Lott (1993)).

These results can be replicated in our setting. We will require two definitions. The cross-price elasticity of the citizen's consumption with respect to the price of cement industry's consumption is defined as:

$$\eta_{rc} = \frac{dx_r^*(p,y)}{dp} \Big/ x_r^*(p,y)$$

Cement industry income and citizen income are substitutes (complements) if $\eta_{rc} > 0$ ($\eta_{rc} < 0$). Now the citizens' income is $x_r^*(1+\delta, y_r^0)$ and thus is increasing in the marginal deadweight cost of transfers if and only if $\eta_{rc} > 0$, i.e. cement industry income and citizen income are substitutes.

Some intuition for this result comes from considering extreme cases. If incomes are perfect complements and the policy maker seeks to maximize the minimum of the incomes of the citizen and the cement industry, then $x_r^*(1+\delta, y_r^0) = \frac{y_r^0}{2(1+\delta)}$, which is decreasing in δ. If incomes are perfect substitutes, and the policy maker seeks to maximize $(1+\lambda)\, y_c + y_r$, then

$$x_r^*\left(1+\delta, y_r^0\right) = \begin{cases} 0, \text{ if } \delta < \lambda \\ y_r^0, \text{ if } \delta > \lambda \end{cases},$$

which is (weakly) increasing in δ. Note that the assumption that only the citizen has income before the transfers matters here. If the special interest had income

also, then increasing δ would (by normality) tend to increase y_r via an income effect.

2.2. Hidden Transfers

Suppose there exists a technologically feasible and less costly way of making the transfers to the cement industry, say, by offering direct subsidies. But if the policy maker paid direct subsidies to the cement industry, it would be clear to the public he was making transfers to the special interest. They might also suspect that protection was a way of making transfers to the cement industry, but they would not be sure.[2] The policy maker might argue that protection was a Pareto-improving policy because of the dynamic externalities. In both democracies and authoritarian regimes, policy makers have incentives to make transfers to special interests but also have incentives to hide the fact that they are doing so.

Tullock (1983, 1989) proposed this explanation of inefficient transfers. In Coate and Morris (1995a), we formalized this story and identified four conditions under which a policy may be an effective hidden transfer mechanism. First, the policy must benefit groups the policy maker wants to benefit (i.e., the policy maker wants to make transfers to the cement industry). Second, there must be ex ante uncertainty about whether the policy also serves a public interest (i.e., the public thinks protection *might* generate dynamic externalities). Third, the public is less informed about the impact of the policy than the policy maker (i.e., the policy maker *knows* that protection helps no one but the cement industry). Fourth, the public never discovers the truth for sure (i.e., the public thinks it possible that the protection served the public interest even after it is implemented). The key to the hidden transfers explanation is that the policy maker is concerned about his reputation (he does not want the public to believe that he is trying to make transfers to the cement industry). The policy maker is then concerned not only about the deadweight costs of alternative transfer mechanisms, but also about the reputational cost to him if carrying out transfers in a transparent way.

It is hard to draw any general conclusions about the desirability of policy conditionality if bad policies are hidden transfer mechanisms. Of course, the World Bank might aim to prevent all transfers (including hidden ones), but we argued above this was unlikely to be feasible. If one particular hidden transfer

[2]Since the costs of protection are spread widely across the population, it may be that no one has sufficient incentive to become informed.

mechanism is banned, there is no way to predict ex ante whether the next best, from the point of the view of the policy maker, would entail more deadweight costs or less (it might have less deadweight costs but be more transparent and thus have a high reputational cost for the policy maker).[3]

3. The Long Term Impact of Policy Conditionality

3.1. Internalizing Policy Reform and Policy Persistence

Policy conditionality may sometimes be used to persuade policy makers to carry out beneficial reforms which - in the absence of policy conditionality - they would not have carried out. But presumably policy makers will abandon these reforms once the financial incentive disappears. Put simply, if policy conditionality is required in the first place, it is presumably because policy makers do not like the reforms, so our first guess should be that reform will be abandoned once the conditionality disappears.

Yet Bank policy is clearly based on the premise that the reforms induced by policy conditionality will be permanent. Indeed, Bank analysis puts much emphasis on the need to "internalize" policy reform so that the government "owns" the reform program (see, e.g., World Bank (1988) chapter 4). This seems odd, since, we re-iterate, if policy makers were not opposed to the reforms, conditionality would not be required in the first place. One motive for this view would be that policy makers are incompetent and that short run conditionality allows them to see the error of their ways.

Suppose, however, that policy-makers are not incompetent. Are there reasons to believe that short run conditionality will have long run effects? This view is certainly implicit in much Bank analysis, although the actual mechanism is not

[3]The hidden transfer story also suggest actions other than policy conditionality that might be in the World Bank's interest. If the World Bank could credibly inform the public that protection was just a hidden transfer mechanism, the policy maker would abandon the policy, even without policy conditionality. But again, it is unpredictable what the net effect would be. Another World Bank policy might be to directly transfer resources to cement industry, thus removing the stigma to the policy maker of having made a transparent transfer. If we believe that policy makers do not carry out economic reforms because the reforms would hurt special interests to which the policy makers are beholden and the political costs of making transparent transfers is too high, then a World Bank policy which had the effect of compensating unpopular losers from economic reform might be cost effective.

described.[4] Our main purpose in this section is to try and identify reasons why policies might have a tendency to *persist* in the sense that their prior introduction makes it more likely that they will remain in place in the future.[5] In the remainder of this section, we will outline a number of alternative explanations of policy persistence. Each explanation will also have somewhat different implications for the long run impact of policy conditionality.

3.2. The Conventional Wisdom

The conventional wisdom is that interest groups representing net beneficiaries will form to defend reforms, so that even when conditionality disappears, there is political pressure to maintain them. The introduction of a reform sets up a system of interest group politics which then dominates political decision taking. Support for this position is garnered from the obvious historical importance of interest groups in the maintenance of many resilient policies.

Unfortunately, this "explanation" is incomplete. In any political system, interest groups will form in response to economic and political incentives. If cement consumers have the capacity and incentives to organize an interest group to successfully lobby to *maintain* the reform, then they would presumably have the capacity and incentives to *introduce* the reform were it not already in place. This being the case, protection would not be operative in the future irrespective of whether it was eliminated in the present. The current introduction of the reform cannot then be held responsible for its future presence. The standard explanation simply fails to answer the key question: what is the *mechanism* by which the introduction of the reform alters incentives in the political process in favor of preserving the reform?

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[4] As Mosley and Toye (1988) point out:

> (The World Bank) has consciously and deliberately laid siege to the high ground of economic policy-making in recipient countries. However, it has done so without any strategy - except the promise of further money - for strengthening the forces supporting its own programme of reform in relation to the forces which oppose it (page 409).

[5] If an interest group has sufficient power to induce a policy in this period, it is likely that they will have that power next period too. However, this does not reflect policy persistence in our sense unless the introduction of the policy has an effect on the second period choice of policy.

3.3. A Private Investments Explanation

In Coate and Morris (1995b), we develop a private investment theory of policy persistence. The idea is that when an economic policy is introduced, agents will often respond by undertaking actions in order to benefit from it. These actions increase their willingness to pay for the policy in the future. This extra willingness to pay will be translated into political pressure to retain the policy and this means that the policy is more likely to be operative in the future.[6]

Consider again the cement industry example. Suppose a protection policy is in place. Industrialists will have responded by making costly investments in domestic cement plants. This investment is sunk. The value to these industrialists of protection is now enhanced by the value of their sunk investments. Their "willingness to pay" for protection has gone up. If the political process is sensitive to the interests of these industrialists, past protection implies a higher likelihood that protection will be in place in the future. In particular, if protection was believed to be the economically optimal policy in the 1950's, it may remain in place in the 1970's even when the policy has been shown to be a pure transfer and even though it would not be in place if it had not been implemented in the 1950's.

Now suppose that protection is removed for the duration of the 1980's. Industrialists will respond by running down their cement plants and investing in outward-oriented industries. Again, this investment is sunk. The industrialists might still wish to see protection for the cement industry. But their willingness to pay for protection has been diminished as a result of sunk investments during the 1980's. In addition, in response to cheaper cement prices, industrial users of cement will have developed greater reliance on cement and will therefore be willing to pay more to prevent protection of the cement industry. Thus if protection was removed by World Bank policy conditionality during the 1980's (against the wishes of the policy makers) it might remain in place in the 1990's (after policy conditionality is removed) because of the induced decrease in the net willingness to pay for the policy.

In Coate and Morris (1995b), we presented a simple dynamic model of this

[6]This mechanism is also discussed in Rodrik (1991). He argues that the probability that a policy reform is kept in place in the future will depend positively on the responsiveness of private investment to the reform when it is initially introduced. "The greater the investment response, the more likely entrenched interests will be created in favor of the continuation of the reform" (p. 237).

phenomenon. We will sketch the idea of the model, in order to make clear what features are required for this explanation of policy persistence. Consider a single firm which can operate in one of two sectors; the cement industry and industry x. The firm can switch sectors at any time, but switching is costly. At the beginning of period one, the firm is operating in the cement industry. There is a public policy (protection) which favors the cement industry. We assume that the impact of the protection is larger than the switching cost, so that the firm's short term interest is to move out of the cement industry if the policy is not in place and into it if it is, despite the fact that the switching cost must be paid.

For purposes of analyzing the impact of policy conditionality, we can focus on a simple question. Consider a two period model where protection may or may not be in enacted in either period. We take the first period policy to be exogenous, but model the choice of second period policy by a policy maker. We suppose that the second period policy maker trades off the welfare of the "citizen" with bribes received from the firm. The payments made by the firm can be interpreted more broadly, however: all that matters for our analysis is the choice of policy is sensitive to the willingness to pay of the firm.

Now if the policy maker cares mostly about bribes from the firm, he will always enact protection in the second period. If the policy maker cares mostly about the welfare of the citizen, he will never enact protection in the second period. For our *policy persistence* result, we assume that the policy maker's preferences are in some intermediate range, i.e. the policy maker is *moderate*. In this case, we are able to show that protection will be chosen in the second period only if it was (exogenously) in place in the first period.

The logic of the argument is straightforward and comes in two steps. For the first step, we show that protection will be implemented in the second period only if the firm stays in the cement industry in the first period. *If* the firm stays in the cement industry, its willingness to pay for protection in period two is higher than if it had left, and - given our assumption of policy maker moderation - the firm's increased willingness to bribe is enough to maintain protection in the second period. For the second step, we show that the firm's decision as to whether to stay in the cement industry is determined by the first period policy, i.e. the firm stays in the cement industry only if protection is in place. Note that the firm takes into account both its first period profits and the effect of its decision on the second period outcome.

This simple analysis is sufficient to explain a long run impact of policy condi-

tionality. If the first period policy maker can be induced to abandon protection (by policy conditionality), then the reform will be maintained in the second period *even though there is no policy conditionality in the second period*, and even though protection would have been maintained in the absence of policy conditionality.

The above analysis provides some insights into the likely long run impact of policy conditionality. It suggests, that if current policy makers can be induced to introduce policy reform, the investments of private agents in response to the policy reform will reduce the net willingness to pay for the policy in the future. In this sense, policy conditionality is internalized.[7] Thus, if part of the purpose of policy conditionality is to make the political climate more favorable to reform policies, the key is to focus on policies which induce the private sector to make investments which can only by protected by the maintenance.[8]

3.4. Asymmetric Information about the Status Quo and Reform Policies

In a model in which decisions are made by majority rule, Fernandez and Rodrik (1991) show that uncertainty about the distribution of gains and losses from a policy reform can lead to the reform not being undertaken, even if it would be supported once introduced. In such circumstances, the reform would be in place in the future if and only if it were introduced in the present. In their argument, uncertainty alters voters' preferences over policies in ways which, under majority rule, favor the status quo policy. As they note, the point generalizes to decision rules other than majority rule. For example, Olson (1965), Becker (1983) and others argue that a more concentrated distribution of benefits may produce more political pressure than a diffuse distribution. Under this view, eliminating uncertainty will produce more political pressure if the ex-ante distribution of benefits is more diffuse than the ex post distribution.

To apply this argument to our example, it would have to be the case that there was uncertainty about the benefits and costs of removing protection from

[7]To give one concrete example, the Turkish industrial sector once vociferously opposed outward-looking reform policies (Atiyas (1994)). However, once those policies were put in place by a military dictatorship, apparently insulated from special interest politics, the same industrialists invested in export markets. Once Turkey returned to democracy, those investments were presumably part of the reason those industrialist no longer opposed the reform policies.

[8]Boycko et al. (1995) argue that Russia's privatization program was successful precisely because it created the political forces to ensure its success.

> As part of a reform package with policy conditionality, (1) the public investment plan of country X is subject to review (i.e., veto) by the World Bank; (2) the total budget deficit is subject to review (i.e., veto) by the I.M.F.; but (3) the regional distribution of the recurrent budget is *not* subject to review by anybody. The government proposes building a cement plant in the West of the country. Bank economists argue that the economic rate of return is too low. The cement plant is vetoed.

The analysis of section 2.1 suggests that this may be flawed policy. The very fact that the Government was prepared to incur the deadweight costs associated with transferring resources to the West by building the cement plant suggests that the West is very important in the Government's calculations. Quite possibly, the Government will react by, say, hiring more Westerners in Government positions, a policy which may leave both the East and the West (and thus presumably the World Bank) worse off. The basic flaw of this hypothetical Bank policy was to believe that it makes sense to distinguish "economic" decisions (the investment program) from "political" decisions (the distribution of the recurrent budget).

We will conclude by reviewing some lessons from our analysis.

- A considerable portion of government activity in most countries is devoted to the transfer of resources between different groups. If the "bad" policies that the Bank wishes to ban are in fact transfer mechanisms, then it is necessary to take into about second order effects of banning them. Bank conditionality never covers all policies, so there will be feed on effects. Our analysis suggested that if policy makers are using the cheapest ways of making transfers, it is far from obvious what these effects will be (section 2.1).

- Incomplete information about policy can play a number of different roles. If policy makers know which policies are transfers but their political constituencies do not, then policy makers may make transfers in excessively costly ways (section 2.2). But it is far from obvious what policy conditionality can do about it. On the other hand, if policy makers are misinformed, policy conditionality might play a role in forcing them to learn.

- If policy conditionality is to have permanent effects, it must be because there exist political or economic mechanisms which ensure that the imple-

mentation of a policy in the past increases the likelihood of its being in place in the future, i.e. policies must persist. If policy conditionality is to have long term effects, it should be designed with a clear view of the relevant mechanisms creating policy persistence. For example, reform policies which create incentives for private investment will have a tendency to persist not merely because the private investment is beneficial but also because the private investment alters the "willingness to pay" of interest groups for policies in ways which favor the reform policies.

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