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On the Political Sustainability of Economic Reform

by

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Abstract

This paper provides a selective survey of the new literature on the political sustainability of economic reform. This literature provides useful insights into the interactions between a country's initial economic conditions, institutional structure and nature of the political system, and the political sustainability of alternative policy choices. These policy choices involve the speed, depth and sequencing of reforms, their distributional aspects, and the availability of foreign assistance.

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I. Introduction

The issue of the political sustainability of economic reforms has come to the forefront in recent years as many countries engage in transforming their economies to market-oriented systems. While the countries in Eastern Europe and the former Soviet Union have received the most attention in this context, the issue is far more general. Indeed, virtually any government has to assess the political consequences and sustainability of its actions, including possible delays in the implementation and effects of the reform measures it is undertaking. 1/

A politically sustainable reform package can be defined as one for which there is sufficient political support to carry out the reforms to their completion. This political support can take various forms; for example, the re-election of the government that started the reforms, a sufficient degree of parliamentary support for reforms, and a large degree of social acceptability.

The purpose of this paper is to examine how economic factors interact with political and institutional ones in determining whether an adopted reform program will be continued. There is a small but growing economics literature that addresses the issue of political sustainability of economic reforms. In the past, its main focus has been on issues such as agricultural reform or trade liberalization in developing countries. 2/ Many of the more recent contributions have studied the process of economic transformation in previously centrally-planned economies (PCPEs). This literature considers reforms that are in a broad sense efficiency-enhancing. It implicitly assumes that this is known to policymakers and the public, and examines why such

1/ The recent volume edited by Williamson (1994) contains an extensive discussion of policy reform experiences, with particular emphasis on the interaction between economic and political aspects of the reform process.

2/ See, for example, Krueger (1993) and Magee, Brock and Young (1989).

reforms can nevertheless fail to maintain political support. ^{1/}

These studies are part of a wider area of research, sometimes called "new political economy", that studies the interaction between political and institutional factors and macroeconomic policy formation by using the tools of mainstream economic analysis and game theory. Researchers in this area have developed theoretical models where economic policy is determined endogenously, as an outcome of the interaction among different agents. These models seek to provide a better empirical explanation of macroeconomic policy decisions than conventional models in which policy is chosen either exogenously or by a benevolent social planner.

Economic policy formation is analyzed by the "new political economy" from both a normative and a positive perspective. The normative perspective is particularly present in the analysis of how institutions affect policy formation, because of its implications for institutional design. This perspective is very relevant today given the radical economic transformations undertaken in PCPEs, the emergence of new countries and the debate on the shape of European Community institutions, such as the European Central Bank. The positive perspective is also important from a policy point of view because it can give insights on the type of policies that are more likely to emerge from specific political and institutional settings, and therefore assist in the design of politically sustainable policies. The insights and findings of this literature have a direct bearing on the topic surveyed in this paper. Clearly, this literature clearly cannot provide firm conclusions and a set of policy recommendations guaranteed to ensure the sustainability and success of

^{1/} Rodrik (1993b) and Roland (1993) provide brief surveys of the more recent theoretical literature in this area.

reforms. Indeed, as Williamson and Haggard (1994) put it, "...any problem with a panacea for a solution long ago ceased to be a problem" (page 589). However, the literature does provide useful insights and generalizations on the complex interactions between economic and political factors, whose validity and applicability requires a careful study of actual policy experiences in the reforming country and in others. 1/

The organization of the paper is as follows. Section II lists several of the key initial economic and institutional conditions that affect feasibility and sustainability of economic reforms. Section III examines the economic policy choices facing a government wishing to undertake stabilization and reform, with particular emphasis on the speed and sequencing of reforms, their distributional aspects and the role of foreign assistance. Section IV relates the political sustainability of economic policy choices to the economic, institutional and political conditions. Section V contains some concluding remarks.

II. Structural Features

The structural features of a reforming economy play an important role in determining the feasibility and political sustainability of different reform packages. Among these features we briefly examine initial economic conditions, the institutional structure and the nature of the political system.

1. Initial economic conditions

A number of initial economic conditions have an impact on the sustainability of macroeconomic policy reform. We briefly discuss several conditions of major importance, namely macroeconomic imbalances and

1/ See, for example, the volume edited by Williamson (1994).

microeconomic distortions, income per capita and its distribution, previous experience with stabilization plans, and informational problems.

Macroeconomic imbalances determine the urgency of reform (i.e. in cases of impending crises), while microeconomic distortions affect the burden-sharing of reform across population groups together with the amount of resource reallocation associated with the removal of the distortions. Cases of extreme macroeconomic imbalances make the status quo unsustainable, and effective stabilization can possibly benefit the entire population. Classic examples are stabilizations following hyperinflation, that seem less costly than the reduction of "chronic" but not escalating inflation. 1/ In a political economy context, authors such as Rodrik (1993a) and Krueger (1993) argue that the adoption of drastic adjustment measures in such unsustainable situations is politically easier: "politics as usual" is suspended, at least temporarily. We further elaborate on this point in Section IV.

A country with a higher income per capita will be better able to withstand the adjustment costs that are typically associated with stabilization and structural reform. At the same time, it may be less likely to undertake reforms because it starts from a better initial situation. Reform programs in countries with a more unequal income distribution need to address the impact of those measures on the lower-income groups. A skewed income distribution can also be an obstacle to reform, as it is often associated with a sharper polarization of society that makes it more difficult to reach consensus on policy measures. For example, Berg and Sachs (1988) find that the probability of default on foreign debt obligations is increased when

1/ Sargent (1982) and Dornbusch and Fischer (1986) discuss hyperinflationary episodes.

income inequality is higher.

Credibility can be enhanced or diminished by a country's record of stabilization and reform attempts (Rodrik 1989, Dornbusch 1991, Calvo 1989, Végh 1992). Specifically, in countries with a history of failed stabilization and reform programs gaining credibility becomes more difficult. Indeed, a stabilization plan's failure may depend on lack of credibility -- the behavior of the public will be inconsistent with the attainment of reform goals, thus effectively dooming the plan to failure (e.g. Calvo 1988).

When winners and losers from economic reform cannot be easily identified ex ante, the task of devising workable compensation schemes becomes more difficult (Fernandez and Rodrik 1991, Dewatripont and Roland 1992a,b). On the other hand, resistance to reform may be stronger in cases in which the loser groups are easily identified.

2. Institutional structure

Economic reforms entail a process of change that is heavily influenced by the underlying institutional structure. For example, liberalization of foreign direct investment is unlikely to be effective in the absence of a well defined system of property rights. Fiscal consolidation may be more difficult to attain in an institutional setting with decentralized expenditure centers. The speed of labor reallocation across sectors following structural reforms depends, among other things, on the flexibility of labor market institutions.

An important and widely studied institutional feature is the status of the Central Bank. The independence of the Central Bank from the political process affects the credibility of a government's anti-inflationary stance, as stressed by Grilli, Masciandaro and Tabellini (1991), and Cukierman, Neyapti and Webb (1992). Alesina and Summers (1993) find that OECD countries with an

independent central bank have lower inflation without negative output effects.

Similarly, constraints on fiscal policy imposed by the legislature, such as balanced budget amendments, may reduce policy flexibility but, if adhered to, will enhance fiscal discipline. 1/

In countries undergoing far-reaching economic transformation, the institutional structure itself is not invariant. Its evolution is of fundamental importance because it shapes the environment in which future policy decisions will be adopted. The difficulty of studying reform sustainability is, however, enhanced for countries in which institutions and "rules of the game" change rapidly over time.

3. Nature of the political system

The nature of the political system affects the constraints to which economic reforms are subject. Here we briefly discuss the impact of political fragmentation, political polarization, and the timing of elections on macroeconomic policy formation; the consequences for the sustainability of reforms are sketched in Section IV. 2/

Highly proportional electoral systems can result in political fragmentation. Such systems facilitate the formation of blocking coalitions, thus making it harder to reach decisions on major policy changes. The result is a status quo bias. For example, Roubini and Sachs (1989) show that fiscal imbalances tend to persist in countries with a fragmented political system.

1/ Such budgetary constraints, however, may not be effective during periods of drastic economic transformation. Indeed, Tanzi (1993) suggests that these constraints may cause delays in transferring off-budgetary items, such as social expenditure by public enterprises, to the budget.

2/ Most of the papers surveyed in Section IV assume that policy decisions are taken in a democratic system, either through majority voting (for example, Fernandez and Rodrik 1991, Wei 1993) or through the interaction between different interest or social groups (for example, Alesina and Drazen 1991).

Political polarization, often a result of unequal income distribution, can lead to political instability. Political instability in turn increases policy uncertainty, with adverse effects on investment and growth. Empirically, political instability is associated with inflation (see e.g. Cukierman, Edwards and Tabellini 1992) persistent fiscal deficits (Alesina and Perotti (1993) for developed countries, and Roubini (1991) for developing countries) and lower growth (Alesina, Ozler, Roubini and Swagel 1992). 1/

The imminence of elections can deter policymakers from adopting reform measures that may cause short-term costs, for fear that this would lead to electoral defeat. Incumbents may fear defeat because voters are "naive", as in the literature on "political business cycles" or because high costs of adjustment may be interpreted by voters as a signal of government incompetence (Rogoff 1990; Milesi-Ferretti 1992). For example, Alesina (1989) and Alesina and Roubini (1992) provide some evidence that the policy stance of governments changes significantly in electoral years.

III. Economic Policy Choices

This section briefly reviews some of the key economic elements of reform packages, with the aim of providing a framework for the discussion of political economy factors in the next section.

1. Speed, depth and sequencing of reform

Discussion of economic policy choices must differentiate between macroeconomic stabilization, for example the reduction of inflation or of fiscal imbalances, and economic reform, such as trade liberalization, the

1/ On the other hand, political instability can be increased by poor economic performance.

removal of price controls, privatization and restructuring. The time frame of stabilization policies is typically short-term while some economic reforms take longer to implement. Although the traditional distinction between "big-bang" and gradualism is more meaningful for macroeconomic stabilization, for some reforms (especially, price liberalization, trade reform or capital account liberalization) this differentiation can be quite germane. Deeper structural reforms such as large privatization and restructuring, by their nature, are implemented over a longer time span (Fischer 1993).

There is a sizable literature addressing the optimal sequencing of economic reforms that does not directly stress political factors, particularly in the context of trade and financial liberalization (Edwards 1989, McKinnon 1991). Several authors also study the optimal speed of implementation of individual reforms. For example, Mussa (1984) examines trade liberalization from this perspective, under the assumption that resources cannot be reallocated instantaneously and costlessly across sectors.

2. Distributional aspects and foreign assistance

Distributional aspects play a role in economic reform since the economic impact of these usually varies across population groups. 1/ Measures that cushion the impact on the weakest segments of the population -- social safety nets -- may enhance the political sustainability of reforms beyond moral considerations. For example, such measures can be needed following the removal of price subsidies on basic staples or utilities.

However, as Mussa (1984), among others, points out, it is not always the case that those more directly affected by reforms are the lowest-income

1/ For a recent general equilibrium model that incorporates both micro and macroeconomic consequences of stabilization and reform, see Bourguignon, Branson and de Melo (1993).

groups. In such cases, redistributive measures designed to quell opposition to reforms may involve compensation to special interest groups that benefit from the pre-reform policies. Moreover, some stabilization measures, such as inflation reduction, may have positive distributional effects. Various studies suggest that inflation is a regressive tax, whose burden falls disproportionately on lower income groups with limited access to hedging instruments (for example, see Cardoso 1992).

Clearly, redistributive schemes present problems of implementation. These problems can be exacerbated by a weak institutional structure and a lack of administrative capacity of the civil service. Finally, budgetary problems can condition the viability of adopting redistributive schemes. This is especially true for poorer countries with limited access to capital markets, and for countries where reforms take place under adverse external conditions, such as a war or a drastic reduction of transfers from abroad.

Such budgetary problems can be lessened by foreign assistance. In general, foreign credit and assistance allows a country to smooth consumption over time when faced with short-run costs of stabilization and reform. This widens the policy options of a reforming government, and may enable a country to start reforms earlier or choose a quicker pace of reform.

IV. Political Feasibility and Credibility

This section provides a selective review of the "new political economy" literature studying the political feasibility and sustainability of economic reform. This review highlights the interplay between initial economic, political and institutional conditions (Section II) and economic policy choices (Section III) in determining the political sustainability of reforms.

Such a review has no claim to completeness but is rather intended to provide a flavor of the insights this literature provides. 1/

1. Initial macroeconomic disequilibrium

When initial macroeconomic disequilibria are extreme, the "status quo" is clearly unsustainable. In such situations, it may be easier to gather political support for reform measures. For example, Rodrik (1993a) argues that the benefits from stabilization can make it politically easier to simultaneously implement reforms (such as trade liberalization) that involve a greater amount of redistribution among population groups. This can result because the "losers" from reforms are compensated with the gains from stabilization. 2/ Such reforms are more likely to run into political opposition in "normal" times, and may therefore be less acceptable if postponed until stabilization is achieved. This analysis suggests that the failure to combine reforms involving redistribution with measures that benefit the entire population may account for the difficulties in sustaining the momentum of economic reform.

Krueger (1993) makes an argument similar to Rodrik's. She argues that the suspension of "politics as usual" in a period of crisis can facilitate the implementation of reform measures such as trade liberalization. 3/ Over time, such measures can become self-sustaining, as support builds up

1/ For example, we do not discuss the political economy of privatization. On the topic, see Lipton and Sachs (1990b), Bolton and Roland (1992) and Roland and Verdier (1992). For recent general reviews on the political economy of reform, see Haggard and Webb (1993), Krueger (1993), Rodrik (1993b), Roland (1993) and Williamson (1994).

2/ Under less drastic initial conditions, however, stabilization policies may entail intertemporal redistribution of resources (short-run costs in exchange for future benefits) and therefore encounter political resistance.

3/ For a formalization of the role of crises in accelerating macroeconomic stabilization, see Drazen and Grilli (1993). Their paper is further discussed in Section IV.6.

endogenously with the emergence of new constituencies that benefit from the reforms (for example, a larger export sector in the case of trade liberalization).

2. Sequencing and speed of reforms

The importance of designing a self-sustaining *sequence* of reforms is stressed by Wei (1993), who builds on work by Fernandez and Rodrik (1991). He argues that a gradualist approach may be politically feasible while a big-bang, although ex-ante optimal, may not be implemented at all. The key point in his analysis is that a gradual process of reform alters the nature of the political equilibrium by building a constituency in favor of a continuation of reforms. This may allow to circumvent the political difficulties associated with pushing through a comprehensive reform package simultaneously.

Wei's point is illustrated by means of a simple example. Consider an economy with two import-competing sectors, which comprise the majority of "votes", and an export one. After trade liberalization, a fraction of workers from each of the two import-competing sectors are able to switch successfully to the export sector, the beneficiary of the reform. While the proposal to remove trade restrictions in both import-competing sectors may be opposed by a majority, the removal of barriers on imports in just one sector would have the support of the other two sectors. After some labor has been reallocated from the adversely affected sector to the export one, it is possible to remove trade barriers favoring the second import-competing sector, with the support of the (now larger) export sector and the sector hurt by the first reform.

This strategy, of course, is based on the assumption that majority support is sufficient to guarantee the completion of reforms. A danger is that the second import-competing sector may have time to organize itself against

the reform, thereby leaving the reform only partial.

A superficial look at the literature on the political sustainability of alternative sequencing of reforms may convey the impression that different authors arrive at contradictory conclusions. For example, Martinelli and Tommasi (1993) study a case in which from an efficiency standpoint a gradual (sequential) implementation of reforms is optimal, but only a simultaneous implementation is politically sustainable. On the other hand, Dewatripont and Roland (1993) emphasize that a gradual approach to reform may ensure political sustainability, while a "big bang" may not. We try to show the common features and disentangle the key assumptions behind such different conclusions.

A closer scrutiny of the two papers mentioned above reveals that the political sustainability of alternative sequenced reforms depends crucially on whether the interruption of reforms necessarily implies a rollback of those already implemented, and on the costs of this rollback. These papers are discussed more at length below.

The general point illustrated in Martinelli and Tommasi (1993) is that time inconsistency problems may require the "optimal" sequencing of reforms to be altered in order to guarantee its political feasibility and sustainability. These problems result because in their framework different reforms entail different winners and losers. They consider a case in which a simultaneous implementation of all reforms is superior to the status quo, but inferior to sequential reforms. For example, trade liberalization may be advisable prior to the establishment of capital account convertibility, although a full liberalization of the external sector is more desirable than inaction.

Their argument is that once a reform has been adopted, its beneficiaries

have no incentive to support further reforms should these hurt them and favor other groups. This makes a sequential strategy harder to sustain politically. By contrast, a strategy of implementing reforms simultaneously, although less efficient, may be easier to sustain politically because on balance everybody gains although every reform taken individually will hurt some group.

The implicit assumption made by Martinelli and Tommasi (1993) is that no reversal of previous reforms occurs if subsequent ones fail to obtain approval, so that winners have an incentive to withhold further support. Dewatripont and Roland (1993) assume instead "complementarity" of reforms. That is, the interruption of reforms implies a costly reversal of previously implemented ones so that partial reform situations are unstable. 1/ Clearly, if the failure to implement subsequent reforms implies a rollback of previously adopted ones, the time inconsistency problem emphasized by Martinelli and Tommasi (1993) vanishes, because the gains of the winners are now at risk if reforms are rolled back: a gradual implementation of reforms becomes politically sustainable.

According to Dewatripont and Roland (1993), the rollback of previously adopted reforms is not without costs, and these costs rise as reform progresses. Consequently, a big bang strategy, defined as the simultaneous implementation of reforms, is very costly to reverse. This may hamper its political sustainability at the very start, especially if voters believe that it may fail to yield improved results. By contrast, a gradualist strategy retains the option of reversal should reforms prove unsuccessful, and is therefore easier to sustain politically.

1/ For a formal analysis of partial reform in the context of centrally planned economies, see Murphy, Shleifer and Vishny (1992).

In their argument, also elaborated in Roland (1991), sequencing tactics are of crucial importance. They stress the need to build a constituency in favor of reform continuation, as in Wei (1993). This is more likely to be attained, they argue, by choosing a "path of least resistance" (in political terms) for reforms. Reforms that are likely to yield benefits across all groups are clearly easier to implement politically, and should therefore be adopted first. Because of these benefits, undecided voters come to view reforms more favorably, thereby building a constituency in favor of their continuation. This facilitates approval for politically more difficult reforms. Choosing such reforms first may instead break the momentum of reforms, as undecided voters may end up opposing their continuation in a climate of political conflict.

One should note that the feasibility of such an approach to reform hinges crucially on the assumption that stopping the reform process is paramount to abandoning it altogether -- in other words, that one can move forward or backward, but not stop. 1/ Kornai (1990) states that the political process will endogenously choose the "path of least resistance" but that this can mean partial solutions and postponement of more difficult decisions. Furthermore, the argument that voters' support is increased by early results contrasts with concerns about "reform fatigue" and "voters' impatience" (Bruno 1992). If the choice of speed and sequencing significantly affects the distribution of the costs of reform over time, these concerns would call for a "front-loading" reform approach, so that higher costs are borne at the time reforms are most popular.

1/ Dewatripont and Roland (1993) argue that it is precisely the complementary nature of reforms that makes a gradualist strategy easier to sustain politically.

3. Speed of reform: the case of restructuring

Economic restructuring typically involves sectors where resources are employed inefficiently, and in which a move towards efficiency requires labor shedding and a more intensive use of remaining resources. If the political situation is such that "restructuring" requires the support of a majority of workers in the sector, these may need to be compensated to relinquish their jobs. According to Dewatripont and Roland (1992a, b) the task of designing workable compensation schemes is that the government does not know how workers differ in their employment opportunities outside the sector. This is a reflection of a more general problem in PCPEs: the existence of "hidden rents" from the current status quo that cut across social groups, such as housing privileges, legal and illegal parallel activities, etc. 1/

In such a situation, although rapid restructuring would be efficient from a production viewpoint, it would entail a higher budgetary cost because of the need to compensate laid-off workers with "good" outside opportunities as much as workers with "bad" opportunities. By pursuing instead a gradual approach, these budgetary costs can be reduced and spread over time. This can be achieved by offering first a modest compensation package, thus inducing "good" workers to leave, and then a more attractive package that induces workers with lower outside opportunities to abandon the sector.

Aghion and Blanchard (1993) and Chadha and Coricelli (1993) also emphasize the high budgetary cost of labor shedding during rapid restructuring, in a context in which workers' external opportunities (moving to the private sector) are endogenously determined. These authors argue that

1/ Roland (1991) discusses these rents in more detail, with particular emphasis on the former Soviet Union.

private sector wages may be decreased by unemployment, therefore stimulating private sector job creation. However, they highlight that the resistance of workers to move to the private sector when its wages are lower, together with the budgetary cost imposed by high unemployment (through taxation to finance unemployment contributions) may derail the restructuring process. 1/

4. Credibility and political uncertainty

Lack of credibility in stabilization and reform processes can lead to substantial costs and to the failure of the reforms themselves. This can occur even when the government was initially committed to sustaining the reforms over time. Failure of a stabilization attempt, for example, can become a self-fulfilling prophecy (see for example Calvo 1988, 1989).

In situations in which establishing credibility of the government's commitment to reform is essential as, for example, in cases of inflation stabilization, Rodrik (1989) suggests that the sustainability of reform may benefit from an initial "overshooting", because this would enhance credibility by signalling to the public the seriousness of the government's intentions. This would push the public to choose actions that take the government's commitment to reform as established, thus facilitating reform. For example, wage claims are lower if workers believe the government's anti-inflation resolve in the case of a stabilization. Slower reforms can induce the public to believe that the government's commitment to reform is doubtful, thus leading them to undertake actions that make the plan's failure more likely.

The line of reasoning given above seems particularly relevant for

1/ It should be noted that the overall fiscal burden of gradual reform may indeed be higher than the burden of rapid reform, in present value terms. However, the discussion above suggests that in the presence of borrowing constraints, the speed of restructuring may be dictated by the need to limit its short-run budgetary impact.

countries with a history of failed stabilization and reform attempts, in which the public's initial confidence in the commitment to reform is low. The failure to establish credibility at the beginning of a reform program may make the program more costly if sustained.

Lack of credibility is likely to arise when the political system is fragmented or polarized. When the political system is fragmented, agents can come to doubt the government's ability to ensure sufficient support for reform measures over time, because several groups may have veto power. This can jeopardize the success of reform programs, as these typically require sustained efforts over time. Political polarization and instability, as well as the imminence of elections, can shorten the horizon of policymakers and cast doubts on the credibility of the reform effort.

The existence of costs of reversal of economic reforms suggests a possible link between expected political developments and the speed of reform. In situations in which the political situation following the implementation of reforms is likely to become fragmented or unstable, with a status quo bias, an early and simultaneous implementation of reforms may be the strategy that ensures political sustainability. This occurs because the high costs of reversal may preclude a rollback even in a difficult political situation. A more gradual approach may instead run into political difficulties, as the fragmented or polarized political system makes it harder to implement further reform measures. 1/

1/ We are grateful to Allan Drazen for suggesting this point. On this, see also Lipton and Sachs (1990a).

5. The supply response to reforms

The supply response to economic reforms is of crucial importance in determining their political sustainability. When reforms fail to deliver expected results, or when the costs of the transition period are higher than expected, reform reversal is more likely, for several reasons. First, voters may infer from events that the implemented reforms are ineffective, in which case the reform policy would be in jeopardy. Second, they may believe that the government has been ineffective in policy implementation, and therefore vote for opposition groups less favorable to reform. In the context of inflation reduction, Bruno et al. (1991) underline how delayed output and employment response to reform has been a critical issue even in countries that succeeded in stabilizing their economies.

The political economy literature has so far devoted more attention to the issue of delayed *implementation* of reforms, rather than to their delayed *effects*. 1/ An exception is the paper by van Wijnbergen (1992), that underlines the importance of quick output supply response for the sustainability of reform. In that paper, the author asks whether price liberalization is politically sustainable and derives implications for its optimal speed. He argues that opposition to price liberalization can be motivated by the fear of a low output supply response to freed prices. A gradual removal of price controls can lead to hoarding with the purpose of intertemporal speculation, as prices are expected to rise in the future. The fact that production is withheld from the market while inventories are being accumulated can generate shortages and therefore a perception of low output

1/ See Rodrik (1993b) and references therein. Models of endogenous restructuring and imperfect credibility, discussed above, can also provide a rationale for the delay in supply response to reform.

supply response. This perception can bolster opposition to the removal of remaining controls, as individuals come to expect that higher prices will not be sufficiently compensated by an increased availability of goods.

By contrast, an immediate full price liberalization can eliminate incentives for hoarding and intertemporal speculation, thus enhancing the response of sales to price decontrols. This enhanced response can strengthen the political support for price reform. Therefore, in this case immediate price liberalization is not only more efficient, but also more credible since political considerations are less likely to lead to future reversals.

6. Distributional conflict

The changes associated with the beginning of a process of economic reform will inevitably give rise to distributional conflicts. Such conflicts are likely to emerge in cases in which the "winners and losers" from reform are difficult to identify ex-ante, as is likely to be the case in PCPEs. If the political system is fragmented or a large degree of consensus is needed for the continuation of reforms, these conflicts will make it more difficult to sustain politically the reform process. Indeed, they may engender a situation in which the reform process stalls because no sufficient consensus can be gathered for a continuation or reversal of policies (status quo bias).

Recent work by Alesina and Drazen (1991) and Drazen and Grilli (1993) uses models of "war of attrition" to study this issue. These models seek to explain delays in stabilization, and offer insights on the difficulty to sustain a reform process over time whenever distributional conflicts emerge.

A "war of attrition" takes place when two (or more) groups disagree over burden sharing for ultimately necessary policy measures (for example, a fiscal stabilization). Uncertainty is crucial -- if a group knew it would eventually

have to concede, it would be in its interest to do so at the beginning, thus avoiding a costly impasse. As time goes by, each group learns about the "strength" of rival groups (namely, how costly it is for them to concede) or the costs of the status quo. The "war" ends when one or both groups find the continuation of the impasse more costly than conceding or compromising.

A number of factors influences the length of the period of impasse. For example, an unequal distribution of the burden delays adjustment, since losing is more costly for each group. The "war of attrition" formulation may explain why, after an initial set of reforms, the momentum stalls, without resorting to voters' irrationality or myopia. From a policy perspective, the crucial issue is which initiatives may be effective in breaking the deadlock. Eichengreen and Uzan (1992) argue that foreign assistance may have played such a role in the case of the Marshall plan. This point is further discussed below.

Along similar lines, Wyplosz (1993) emphasizes that in the presence of uncertainty about the distributional consequences of reforms, it is harder to sustain them politically over time than it is to start them. He studies the evolution of political support for reforms, starting from the assumption that in the context of a massive adjustment effort, such as the one undertaken by PCPEs, things are likely to get worse before they get better. In his model, reforms cause initial unemployment, but in the long run they raise productivity and lead to full employment.

If things are expected to get sufficiently better in the future and everybody faces the same probability of becoming unemployed, it may be easy to devise ex-ante a redistributive scheme that guarantees sufficient support for the implementation of reforms. Once these are implemented and

unemployment surfaces, however, the redistributational scheme (safety net) may not be sufficient to prevent individuals that are harmed by the reforms from pushing for a reversal of policies. On the other hand, if the government cannot borrow abroad, compensation schemes must be financed through taxes and more generous ones may be viewed as exceedingly onerous and thus be opposed.

Wyplosz also stresses that domestic capital markets may not be sufficient to overcome these problems. The reason is that everybody would like to borrow in bad times to avoid large drops in consumption so that people that are most adversely affected in the initial reform stages may have to pay very high rates of interest as a result of the increased demand for funds. In such cases access to international capital markets, by private agents or the government itself, could help alleviate the costs of transition and hence facilitate political sustainability. Their role is all the more important when the public becomes more "impatient" as reforms proceed, a case of what Bruno (1992) calls "reform fatigue". 1/

7. Role of foreign assistance

A key issue is whether foreign credit and assistance can enhance the political sustainability of reform, and if so through which channel. The general argument about the benefits of foreign assistance is that it can reduce the short run costs of adjustment of reform, thereby making the adoption and continuation of reforms more likely. Along these lines, Sachs (1989) has argued that foreign assistance can strengthen the position of

1/ The design of redistributive schemes needs to address the possibility that "social insurance" may encourage private behavior that exacerbates the costs of the schemes. For example, Coricelli and Milesi-Ferretti (1993) point out that the perception of political constraints that prevent the government from letting unemployment rise may induce excessive wage claims. This would make it more likely that the government will have to intervene ex-post to bail out firms, especially if the initial downturn in economic activity is substantial.

reformers and therefore enhance the political sustainability of reforms.

In the context of a discussion of the Marshall Plan, Eichengreen and Uzan (1992) highlight how limited amounts of foreign assistance may allow to break a "war of attrition" deadlock because they allow a reduction in the short-run burden of reform. In such a context, the *design* of foreign assistance becomes of crucial importance. For example, while a reduction or a more equal sharing of the burden of adjustment contributes to an early resolution of the impasse, forms of assistance that raise the benefits of "winning" may instead protract the deadlock, because giving up or compromising becomes more costly.

V. Concluding Remarks

The design of economic reforms requires a careful consideration of the political and institutional environment in which these are implemented, and of the distributive consequences of the reforms. We have examined studies of economic reform that incorporate not only economic but also political factors. These studies examine complex economic and political changes affecting some reforming countries, and are by necessity very stylized. Nevertheless, they are helpful in understanding how initial economic conditions, institutions and nature of the political system interact with reform policy choices in determining their political sustainability. Resolving distributional conflicts and building constituencies that support the reform effort are crucial in determining the political sustainability of reform.

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