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THE SEQUENCING OF STRUCTURAL ADJUSTMENT PROGRAMMES: WHAT ARE THE ISSUES?

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1 THE TIMING OF ADJUSTMENT: THE BIG BANG VERSUS GRADUALISM

Developing countries' experience of the process of structural adjustment has frequently posed the question of how to *time* the policy changes that economic reformers try to implement. In the early 1990s, two different approaches to this question of timing were widely debated. On one side of the argument were the advocates of the "big bang" approach. They said that comprehensive stabilisation and liberalisation measures should be introduced immediately at the start of the reform process and implemented as fast as possible. They were the advocates of speed and stealth in a top-down style of reform. The classic example of this is the reforms carried through by Leszek Balcerowicz in Poland in 1990-2 (Rodrik, 1996: 34; Williamson, 1994: 153-77). The supporters of the big bang in Eastern Europe and the former Soviet Union were, however, influenced by unacknowledged political considerations. They detected a very brief window of opportunity to demolish the economic structures that underpinned state socialism, before disillusion with "capitalism" set in.

On the other side of the argument were the advocates of gradualism. They pleaded for the stretching out of the reform measures over a longer time period. They reasoned that this would ease the pain of the adjustment process, allow time to develop a political consensus in support of the reform process and thus make it more politically sustainable. To this plea, the "big bangers" retorted that any procrastination would add to the total costs of adjustment and would, contrary to the rationale for gradualism, make the whole adjustment process *less* politically viable, by allowing opponents of reform time to marshal their forces of political obstruction.

This paper will focus first on the problem of the timing of reforms, and what welfare economics and political economy each contribute to its resolution (in sections 2 and 3). It is then suggested that both of these contributions are partial, but are mutually compatible within the framework of Critical Path Analysis (CPA). Section 4 provides a brief case study of some sequencing problems that have arisen in the recent Indian economic reforms. Section 5 concludes the paper with a consideration of the utility of the use of the CPA

method for the management of reform sequences, and the issues that need further investigation.

Turning first to the issue of the timing of adjustment reforms, it is important to note that neither the “big-bangers” nor the gradualists had much to say about the problem of the optimal sequencing of reform measures. The “big bangers” urged the necessity of the *simultaneity* of all reforms, be they stabilisation or liberalisation measures. By definition, this is a denial of the need for any kind of *sequencing* of reforms. On the other hand, the advocates of gradualism assumed that all reforms would be costly in welfare terms and that, without democratic consensus building, they would be politically de-stabilising. This led them to ask simply for *more time* for reform, without considering whether the reform timetable that was already in place could be re-arranged to better effect. Fortunately, by the 1990s, awareness of the problem of optimal sequencing of structural adjustment policies had grown more widespread. McKinnon argued that “there is an “optimal” order of economic liberalisation, which may vary for different liberalising economies depending on their initial conditions”, but which nevertheless does have “common characteristics” (1991: 4). At the same time, some authors realised that the problem of optimal order was not one solely of economic logic. “There is a certain tension in the integration of economic policy recommendations based on economic analysis with those stemming from the consideration of political economy factors” (Fannelli and Frenkel, 1993: 77). How might this tension be analysed and resolved?

Suppose that one were to think of the implementation of a set of structural adjustment policies as a very large project, composed of a myriad of inter-related activities. Suppose one then were to ask oneself how this very large project could be managed in the most efficient way. The thought occurs: is not this a familiar problem in operational research? If this is so, and the analogy between the management of economic reforms and the management of a very large project - whether physical or institutional - is sound, it would imply that a solution to the sequencing problem might be found by applying an operational research method. The method in question is critical path analysis.

Let us now explore the economic reforms/large project analogy more closely. The difficulty of managing efficiently any very large project arises because of certain characteristics of the inter-relationships of the many discrete activities

that are involved in the completion of the project (MacCrimmon, 1987). The three key characteristics are:

- *There is a precedence ordering of some activities.*

Although some of the activities may be able to be undertaken simultaneously, others will have to follow a required order or sequence in time. Thus even when there is only one way to perform an activity and when the completion time or duration of an activity is known for certain, there is always a problem of determining when that activity can begin.

- *There is uncertainty about the duration of activities*

The completion time of some activities can be known with certainty, but the completion times for many others are uncertain. Unexpected negative shocks will delay the completion of some activities, while favourable shocks may advance completion dates for others. However, because of the order of precedence that does apply to *some* of the activities, not all delays and speed-ups of particular activities are equally significant (or “critical”) for the completion time of the entire project.

- *Activities have alternative designs that are more costly*

There may be only one way to perform some activities, but for others there may be more than one way to achieve the intended outcome of the activity. Since, under assumptions of rational behaviour, the option that minimises cost would have been chosen first, other options would have higher resource costs. Nevertheless, it may be worthwhile to incur the extra costs of the re-design of activities that are critical, because of the difference that they make in shortening the completion time of the entire project.

Thus, managers of very large projects need to know which activities are critical in the above sense. For that purpose, a critical path analysis (CPA) is undertaken. The CPA requires that all the activities of the project must first be specified, along with the minimum time needed for them, and then they must be placed in their order of time precedence. The critical path of operations is the longest path through the entire network.

The idea of the CPA method can be used as a heuristic device to re-consider the question of the sequencing and sustainability of structural adjustment programmes. Much of the existing literature on this question is cast in terms

of one or the other of two quite distinct approaches (for example, Kanbur, 1995). One of these is welfare economics, which is concerned with how changes in economic policy affect the welfare of individuals, groups and thus society at large. The other is political economy, which examines how those who stand to gain or lose from the policy changes will react or fail to react by organising themselves to operate in the political process. The argument being made here is that, within the larger framework of the CPA method, the insights of welfare economics and of political economy can become complementary.

To date, unfortunately, they have usually been seen as conflictual. What frequently happens in the debate over economic reforms is that orthodox welfare economists try to demonstrate that the reforms will increase welfare. Having done so to their own satisfaction, they then urge governments to implement them forthwith, wringing their hands and shaking their heads if governments fail to do so. For their part, the political economists see that the reform agenda creates political conflict and power struggles, and infer from this either that economically desirable reforms are politically infeasible, or that politically feasible reforms are economically undesirable, for example because of a presumed negative impact on the poor. It would be easy, but tedious, to document these sorts of alignments in current debates on the implementation of stabilisation and liberalisation measures.

Since these battle lines are so familiar, it may be more profitable to try to go beyond them. Let us ask instead what welfare economics and political economy each have to contribute to the analysis of economic reform, when it is viewed as a very large project, whose management requires the minimisation of the duration of its “critical path”, in the face of a variety of stochastic shocks. In the next section, the potential contribution of welfare economics is considered from this perspective. This is followed in Section 3, by a discussion of the potential contribution of political economy.

2 WHAT DOES WELFARE ECONOMICS SAY ABOUT THE SEQUENCING OF REFORMS?

What does welfare economics teach us about the sequencing of policy changes, in particular measures of stabilisation and liberalisation? The lessons are surely not very abundant. Furthermore, the main difficulty of the search for relevant lessons lies deep in the entrails of economic theory, which in many of its manifestations simply abstracts altogether from the dimension of time. Many of the great economic theorists of the past have struggled to incorporate a time dimension into fundamental economic theory, and with limited success (Currie and Steedman, 1990). As one modern development economist has noted, “Our theories.... do not provide us with a satisfactory analysis of timing and sequencing. That is not a subject which can be analysed very easily and it is not one on which economic theory has progressed very far” (Stern, 1989:21).

The standard starting point in orthodox welfare economics is the economic theory of the second best. This begins with Pareto’s theorem that a general equilibrium of markets brought about by freely adjusting prices maximises economic welfare (assuming that the existing distribution of assets and income is optimal). This is because, in general equilibrium, no further welfare improvements are possible by means of re-allocating resources. It is no longer possible to make any one better off without at the same time making someone else worse off. If this is so - and if the underlying distribution assumption is also accepted - an economy without any constraints to impede the emergence of a general equilibrium must be preferable to an economy where such constraints (often called “economic distortions”) do exist, and where therefore there are barriers to welfare improvements. So far, so good. But this logic does not also prove that any single move towards the ideal undistorted economy also increases welfare. Eliminating one distortion while leaving others in place may reduce welfare rather than improving it.

It is easy to see intuitively why this is so. One distortion may be counterbalancing the effect of another distortion. In this case, if one is removed, but not both, the economy may become more distorted rather than less distorted as a result. It is also easy to see how the theory of the second best is related to the advocacy of the “big-bang” approach to adjustment. Only when *all* distortions are swept away *simultaneously* does economic theory appear to guarantee that

the result will be welfare improving. However, it is very important to ask, “what kind of a guarantee is this?” It is hardly a very reassuring one, once we have read the small print. The reason is that the theory of the second best also lacks any time dimension. It rests on a static comparison of a disequilibrium situation with an ideal equilibrium, ignoring both the dynamic path of transition and the time that such a transition takes to complete. Advocates of the “big-bang” approach therefore actually rely on a further assumption, namely that the process of equilibration is instantaneous, or at least so rapid that the problem of the path of transition can be neglected. This assumption is embedded in, for example, the monetary approach to the balance of payments developed at the University of Chicago, and applied with disastrous welfare effects by Chicago-trained economic policy-makers who were guiding the Chilean economic adjustment process between 1976 and 1981.

The theory of the second best does, however, have a particular relevance to the the question of appropriate sequencing of structural adjustment, when this term is defined to include both the stabilisation and the liberalisation of the economy. As already discussed, the theory analyses the welfare implications of different moves from disequilibrium to a general equilibrium of markets, and especially the different welfare implications of the removal of microeconomic distortions all at once or piecemeal. The results of this analysis are, as just mentioned, inconclusive, and of no help to the policy-maker concerned with the sequencing of economic adjustment measures. However, one aspect of the theory is relevant here. It is that the theory of the second best, like all developments of general equilibrium theory, analyses microeconomic welfare problems on the assumption of macroeconomic stability. The validity of all its theorems rely on the assumption that a stable level of general prices has already been achieved, by some form of monetary policy, so that the relative prices that consumers and producers face are defined in real and not merely nominal terms.

This feature of the theory of the second best suggests that to embark on a programme of economic liberalisation or deregulation before taking measures to stabilise macroeconomic imbalances is a wrong order of precedence, in that it will not produce the desired welfare results. So welfare economics does after all have *something* to contribute to establishing an order of precedence for the package of policy changes. If one were to write any rules of precedence for policy changes, Rule No. 1 of adjustment sequencing would be that

macroeconomic stabilisation must be started first, if there is serious macro-instability. Rule No. 1(a) is that, until stabilisation measures have reached the target values for the fiscal and balance of payments deficits, liberalisation measures should be pursued only to the extent that they are consistent with achieving these stabilisation targets.

At the beginning of the adjustment sequence, policy-makers will almost certainly face a trade-off between the pursuit of macroeconomic stabilisation objectives and the pursuit of their liberalisation objectives. For example, the liberalisation of foreign trade often involves the lowering or removal of tariff barriers to imports, which will reduce customs revenue for imports and *ceteris paribus* increase the size of the fiscal deficit. Again, the liberalisation of the financial system usually has the effect of raising the rate of interest on government debt, and thus *ceteris paribus* increasing government expenditure on debt interest, and thus widening the fiscal deficit. This suggests that tariff reductions and financial liberalisation should not start until stabilisation targets have been hit.

However, certain types of liberalisation measure do contribute positively to reaching the stabilisation goals. For example, the imposition of a hard budget constraint on public enterprises has the effect of reducing public expenditure, and *ceteris paribus* also reducing the fiscal deficit, by eliminating those budgetary subsidies that financed previous public enterprise losses. Again, the replacement of quantitative restrictions by tariffs of equivalent protective effect, which is a necessary preliminary action for trade liberalisation, increases customs duties and reduces the fiscal deficit *ceteris paribus*. Further, the reduction of the rates of export taxes can be expected to switch some exports back from illegal channels to legal channels of export where the tax will be levied. If previously a substantial proportion of exports has been smuggled out, the net effect of the reduced rate of tax and the additional volume of exports that has switched to exiting by legal channels could be an increase in revenue, and *ceteris paribus* a reduced fiscal deficit. So certain liberalisation actions provide a positive reinforcement to stabilisation. The aim of policy-makers has to be to allow the economy to benefit from the benign interactions between liberalisation and stabilisation, and to minimise the effect of the malign interactions. This implies Rule No. 1(b): advance in the sequence of liberalisation measures those that reinforce stabilisation goals, while holding back those that will make stabilisation more difficult.

Before considering this further, let us state Rule No. 2, that stabilisation measures themselves have an appropriate sequence. Since monetary policies are often inadequate on their own to the task of stabilisation, they need to be complemented by fiscal and exchange rate policies. When this is so, the sequencing of fiscal deficit reduction and exchange rate devaluation is itself important. If, for example, the fiscal deficit has not been reduced sufficiently and is still causing inflation at a higher rate than the weighted average rate of the country's trading partners, devaluation will not be effective. Further devaluation will soon be required. This situation does not constitute a restoration of macroeconomic stability. Apart from other consequences, expectations of repeated devaluations will deter inward foreign investment and provoke speculative outward capital movements. These will be attempted illegally, if capital controls are in place, and legally, if they are not. So, adequate reduction of the fiscal deficit must precede devaluation, if the latter is to be stabilising in its effect.

When macro-stabilisation has been given its appropriate priority and reduction of the fiscal deficit is the instrument chosen for this, then care must be taken about precisely how the deficit is reduced. Whether revenue raising is to be preferred to expenditure reduction, or both are to be employed, will depend on the initial conditions of the economy when an adjustment process begins. About this policy choice, there can be no general rule. In some economies, the economic crisis will already have driven public expenditure down to sub-optimal levels, while in others it will be bloated public expenditures that caused the crisis in the first place, and will therefore need to be pruned back. In that case, liberalisation measures that lead to public expenditure reductions will be of special importance.

If the deficit is to be reduced by the reduction of public spending, the cuts should not be arbitrary, either in the form of a reduction of x per cent in all expenditures or reductions only in categories like the purchase of supplies and equipment, which are the paths of least resistance. Such arbitrary cutting merely introduces new distortions that reduce the productivity of the public sector's service provision. Rather the least productive areas of service provision have to be identified and closed down in their entirety. What should remain are those areas of expenditure that act as the most positive incentive to domestic and foreign private sector investment. Good economic infrastructure

(transport, telecommunications, electricity, water) and good social sector services (health, education, social security) will have the desirable incentive properties.

If tax revenue is to be raised rather than public spending reduced, the first step on the road to trade liberalisation, the conversion of quantitative restrictions on imports into equivalent tariffs can be taken early on, because, as already noted, it has its own additional stabilising effect by raising customs revenue. Trade liberalisation proper does not occur until some tariffs are reduced. Once this happens the benign interaction arising from tariffisation of quantitative restrictions is succeeded by the malign one of tariff reductions that lower tax revenue. Since many countries in need of adjustment rely quite heavily for revenue on taxes on foreign trade, this malign effect can be powerful if replacement revenues are not quickly mobilised in addition to the new revenues that will be required to reduce the fiscal deficit. Where to find both replacement and additional revenues? The new taxes should be broad-based, levied on domestic economic activity and themselves non-distorting in their economic effects. These criteria point clearly in the direction of a value-added tax.

As well as these qualitative requirements for expenditure reductions and revenue increases, the reduction of the fiscal deficit should meet a quantitative target. This target will depend on a judgement of how large a deficit can be financed on a sustainable basis, by domestic or foreign borrowing or through the inflation tax. Once the fiscal deficit is being brought down to a sustainable level, by means of the right type of revenue expansions or expenditure cuts, it is prudent to embark on the decontrol of essential imports which will be needed if firms are to be able to respond to a devaluation, or to a process of exchange rate liberalisation which usually is accompanied by a devaluation - either all at once or by means of a crawling peg. Since infrastructure bottlenecks are likely to constrain the export supply response, foreign aid should be sought at this point for rehabilitation projects. One final preliminary action is needed before liberalisation proper is begun. The extent and timing of future trade liberalisation should be announced. It is most important to give a clear advance warning before liberalising the trade current account. This gives a limited time to firms operating in protected industries either to improve their competitiveness, or to diversify their assets into other activities that will not be damaged by the removal of protection. It is all very well to remove barriers to

entry, in order to intensify competition. However, this does nothing to reduce barriers to exit that often exist in poor countries (Nayyar, 1996: 20). Unless domestic entrepreneurs are given enough time to find their way round exit barriers, they will be swiftly crushed by the new foreign competition. Advance announcement of planned tariff reductions also serves the purpose of warning new foreign investors against getting locked into industries in which profits can be made only if existing levels of protection continue.

The debate about the order of precedence of liberalisation measures *once the economy has been stabilised* centres on the order in which domestic financial markets, factor markets (including labour markets), goods markets, foreign trade and capital markets are deregulated. The need for a successful sequence of liberalisation measures is well understood by some, and economists have tried to solve the problem by considering short-term, medium-term and long-term effects of such measures (Nayyar, 1996). The order financial/ factor/ goods/ foreign trade/ capital markets is the sequence which seems best to represent the consensus view. However, this consensus does not rest on much formal welfare economics. Rather, it has arisen from the observation of the results of what have in effect been experiments in different practical settings. Thus the debate is likely to continue, as different types of interaction between liberalisation measures are highlighted by experience and subsequently analysed.

All that can be done here is to give some flavour of this essentially pragmatic discussion. The objective of the 'project' of structural adjustment is not merely to bring about the euthanasia of those forms of economic activity that have been induced artificially, by subsidies, distorted prices, and uneconomic lending and investment. This should be no more than preliminary to releasing resources for the growth of new economic activities that make better use of the resources thereby released. Only if this actually happens will economic growth take place. For success, a strong domestic supply response to the changed prices is imperative. But, evaluation studies of structural adjustment (e.g. Taylor, 1988) have discovered that the supply response to devaluation is often inhibited because the banking system is unable to supply the quantities of credit that are needed by firms as working capital. As is also well established, this credit constraint is far more severe for small enterprises, which are unable to offer the banks any collateral security against failure to repay. Small enterprises include small farms in the rural areas that might otherwise invest in

high-yielding varieties and fertiliser, as well as small businesses in urban areas that might otherwise be able to upgrade their existing technology, or even just meet their start-up costs. Provided that the environment is not fraught with risks so high that they deter investment, much of the success of the structural adjustment project hangs on the health or otherwise of the banking system as a point of access to credit for sound borrowers. Are the banks still encumbered with bad debts and managed by the same staff whose lending decisions incurred those bad debts, or has its balance sheet been cleaned and its management turned over to people who will lend solely on considerations of expected returns? Further, are there good microfinance institutions functioning for borrowers who cannot provide collateral? If so, are they using operating procedures that succeed in minimising, in the absence of collateral, the risk of non-repayment?

The answers to these questions vary greatly as between Asia and Africa. Bangladesh and Indonesia have had mass credit-based rural development programmes in place since the 1970s, that have reached millions of households. Unlike some other similar programmes, for example in India, their repayment record has been good. This has been assisted by devices like granting discounts to those who repay on time, profit-related bonuses for staff and repayment-related incentives for neighbours who act as character referees. Repayments are collected at short intervals at the borrower's house, and the borrower is encouraged to open savings deposits and required to place one-twelfth of the loan in an insurance fund (Mosley, 1994). When financial intermediation for small borrowers is widespread and well organised, inhibitions about retrenchment of public sector workers are greatly eased. Equally clearly, they need to be in place before it is realistic to make progress on labour market reforms. Further, if this sequence is followed, the economy will be well placed to ensure that all the advantage of a liberalisation of the goods markets is not captured entirely by foreign exporters and investors.

Thus the reform of labour and other factor markets should follow financial sector reform, but precede trade liberalisation. The rationale for this sequence is that, if deregulation of labour markets has the effect of reducing formal sector employment, credit should be available on market terms to permit the expansion of informal self-employment. This shift, in turn, is an essential prerequisite for a strong domestic supply response, once trade barriers are

removed and foreign firms are allowed to compete in previously protected domestic markets.

The liberalisation of the capital market is placed at the end of the sequence, for various reasons. The underlying assumption is that controls on the capital market are at least partly effective, and that some capital, either domestic or foreign is retained in the country “unwillingly”. If capital market controls are abandoned before the domestic credit market is liberalised, and therefore domestic deposit rates are still kept artificially low, some of the unwillingly held capital will exit, in search of the higher market interest rate which can be found abroad. This flight of capital will be reinforced to the extent that the domestic currency carries a significant risk of devaluation. If capital market controls are abandoned before the exchange rate is stabilised, capital will flow out even after domestic and foreign real interest rates have been equalised, since savers are able to take an almost costless, and often self-fulfilling, gamble that the domestic currency will be devalued.

The financial crisis that began in Thailand in July 1997 exhibited a particular variant of the latter scenario. Several Asian countries had followed policies of fixing the exchange rate of their currency to the dollar. This meant that they accepted for themselves the whole of the foreign exchange risk of borrowing abroad, as a method of attracting foreign investment. At the same time they maintained or moved to an open capital account. While confidence lasted, all was well. Once the spectre of devaluation was raised in Thailand, other countries with fixed exchange rates had no defence against speculative attacks on their currencies, unless they could turn to a lender of last resort, as Hong Kong could turn to China. These events have underlined the importance of addressing sequencing issues in the liberalisation of the capital account.

If the liberalisation of the capital account accompanies the reform of foreign trade, capital inflows may succeed in the short run in pushing up the real exchange rate and permitting resource inflows into the non-traded goods sector which later have to be reversed (Falvey and Kim, 1992: 913). This is what happened in Chile from 1976 to 1981. Although there are some welfare arguments for small partial capital account liberalisation’s during trade reform, the bulk of the capital account liberalisation is best left until the trade reform is already well advanced.

In countries such as Chile, where the range of reforms has been wide, empirical analysis suggests that malign interactions do arise from adopting the wrong order of precedence in stabilisation and liberalisation, and constitute a major risk to the success of the adjustment project. This risk has been described as “policy inconsistency”. It undermines the credibility of any structural adjustment programme. Once credibility has been lost, economic actors change their behaviour in ways that make the programme fail, even if previous political opposition to it was being successfully contained.

This discussion of the order of precedence of economic reforms indicates that welfare economics can be used to deduce some simple rules that give stabilisation priority over liberalisation measures, except in those case in which the latter reinforce the move towards the stabilisation targets. More loosely related to economic theory, and more informed by lessons of experience. are some ‘rules of thumb’ for sequencing the liberalisation measures themselves, once stabilisation targets have been met. (For the sake of clarity, it should be emphasised here that meeting stabilisation targets is a continuous process, given the existence of stochastic shocks from both internal and external sources and not something that ever is or can be achieved once and for all.) It is reasonable to argue that the economic reform project does have an order of precedence among at least some of its activities. This must throw doubt on the utility of the ‘big bang’ approach, while also showing the limitations of the gradualists’ banner, if all it says is “More Time!”

3 POLITICAL ECONOMY AND THE CRITICAL PATH OF ECONOMIC REFORM

If welfare economics throws some light on the interdependencies in time of the manifold activities of the economic reform project, what is the contribution of political economy? Political economists of economic reform attempt to cover a very broad spectrum of adjustment issues, including the following.

- Political economists have developed theories that attempt to explain, by focusing on ‘urban bias’ or ‘rent-seeking behaviour’ or ‘patrimonialism’, why failures of economic performance should be interpreted not as a series of individual mistakes of policy analysis, but as a syndrome that causes widespread economic distortion (Toye, 1994: 22-26).
- They also investigate the precise combination of circumstances under which countries initially embrace the structural adjustment agenda, including the

role of economic crises, the emergence of new forms of leadership, and changing paradigms of development ('the role of ideas').

- Another political economy topic is the dynamics of the relationship between the government of the adjustment country and the international financial institutions that make its loans conditional on policy changes (e.g. Mosley, Harrigan and Toye, 1995).
- A fourth topic is the comparison of the ability of different types of political regime to initiate and sustain the project of structural adjustment. One question under this heading is whether it is necessary to have a ruthless authoritarian government to discipline the interest groups that benefit from a distorted economy.

Fascinating as all these topics are, and the findings of different researchers who have enquired into them, they are not pursued further in what follows. For the purpose of this paper, special attention is focused on political economy analyses that illuminate the uncertainty that affects the duration of reform activities, and also the possibilities for re-designing activities that lie on the critical path, so that the original timetable of the reform project can be adhered to.

This is quite convenient, and fits in well with the choice of India for our case study. In the case of India, the answers to the first four questions are sufficiently clear. It is enough to state that:

- (1) India had built up by 1991 an economy that grew only moderately fast, with a large and largely unprofitable state enterprise sector and extensive controls over the private economy.
- (2) After the foreign exchange crisis of 1991, the Indian government decided to make a new and more strenuous effort both to stabilise and to liberalise its economy, for whatever reasons.
- (3) In this effort, the international financial institutions have played only a minor part, because they do not have the leverage to be able to pressure the Indian policy makers.
- (4) India has been, and will continue to be a democracy, so that counterfactual comparisons of what might happen under an authoritarian regime are of academic interest only.

The political economy question that is most relevant in India's current situation is that of the management of the reform process. How can a democracy, which has begun a historic break with its past development strategy, carry that project through to a successful conclusion?

The political economy of the *implementation* of economic reforms is concerned with identifying the gainers and losers from particular reforms, and examining whether, to what extent and with what effect each group engages in political action to advance or defend its interests. The standard approach is first to define a discrete set of interest groups, such as large farmers, the landless, industrialists, small entrepreneurs and so on, including politicians and bureaucrats as having their own interests to advance. Then their existing income sources are specified, and the impact of individual economic reforms on their income flow is estimated. It is assumed that the effects of reforms on their own incomes govern the political preferences of each group, and so their support or opposition for reforms is read off from this "pocket-book politics" assumption. In fact, because the poorer groups who tend to benefit from liberalisation also are politically weaker than the richer groups, who tend to lose as a result, the political economy of the pocket-book draws the conclusion that economic reforms will tend to be blocked by a veto coalition.

If the problem of implementing economic reforms is re-thought from the perspective of CPA, what new insights do we gain? It is that the political economy of the pocket book has to be modified in the light of considerations of time. If all the activities involved in the economic reform project were systematically enumerated, the variation with respect to their normal duration would surely be very considerable. Reform activities could indeed be placed along a spectrum, running from those whose normal duration is very brief indeed to those whose normal duration is very long. What is it that accounts for this considerable variation? The time normally required for a given reform activity depends on a number of factors. In particular, it depends on the following variables:

- The extent of the *technical consensus* on the design of the reform activity. Is there a clear agreement among the relevant specialists about how the activity is to be done? Lack of consensus will lengthen normal duration.
- The *amount and current availability of detailed information* required to satisfy the technical criteria in practice. If, for example, complex economic calculations have to be done, is the relevant data to hand, or will it have to

be collected first? Unavailability of relevant detailed information will lengthen normal duration.

- The *number and variety of actors* who need to cooperate in order for the reform activity to be implemented. How many individuals, ministries, NGOs, and other agencies have to collaborate together to achieve success? The more people and institutions have to collaborate, the longer will be the normal duration.

Because of the operation of these three tendencies, it has become commonplace to contrast the quick reforms of altering interest rates and exchange rates, which can be done by a few individuals in a single ministry, with the long drawn out re-organisations of tax systems or sectors such as agriculture, education or health.

It does seem to be the case that the longer the normal duration of a reform activity, the greater the likelihood that gainers and losers will be able to mobilise politically in support of their own interests. They will both have more time to try to penetrate the deliberate opaqueness of government policy, and more time to mobilise their respective constituencies. However, it is likely that the potential losers will be more politically active than the potential gainers, an observation about reform first made by Machiavelli in *Il Principe*. So the longer the normal duration of a reform activity, the more time the potential losers will have to initiate blocking actions, such as strikes, legal challenges and parliamentary filibusters. This means that the longer is the normal duration of a reform activity, the more uncertain is the actual time duration of that activity, and, indeed, the more uncertain is its final outcome.

Because an economy is an interdependent system, economic policies have to be consistent, including the consistency between macroeconomic measures and microeconomic measures of all kinds. It has been argued in Section II that policy consistency has a time dimension, formally so between stabilisation and liberalisation, and more pragmatically so within the different measures of liberalisation. The consistency requirement clearly becomes progressively more difficult to fulfil as more and more sectors are included in the liberalisation process. In response to this difficulty, Rodrik (1990) has suggested that there is a trade-off between the range and scope of liberalisation and the sustainability of structural adjustment. He judges the latter to be more important than the former, so he recommends deep liberalisation in only one or

two sectors, rather than a wide-ranging liberalisation that could destabilise the entire reform process.

Governments can lose a great deal of political capital, defined as legitimacy and credibility, in such set-piece contests. This makes governments wary of provoking them in the first place, especially if the existing situation is providing reliable flows of political benefits. The CPA perspective, however, suggests that there is an alternative to delaying the start of reform activities that seem difficult, or backtracking towards the pre-reform position when opposition manifests itself. In contrast with this passive or reactive approach, the political contest over activities that lie on the critical path could be actively managed. There are ways to do this, for example by designing into the reform activity greater compensation for those who lose from it. This would call for greater resources, and thus would lower the initial benefits arising from the implementation of the activity. Nevertheless, provided the compensation given to losers was of a one-off nature (and therefore partial) and was effective in reducing the additional implementation delay imposed by the political contest, it would be preferable both to avoiding the contest by doing nothing, and to entering the contest and then simply allowing it to take its course.

4 SOME SEQUENCING PROBLEMS OF ECONOMIC REFORMS IN INDIA

The Indian economic technocrats led by Dr. Manmohan Singh, set out on the adjustment path late relative to many other developing countries. This in itself was a significant initial handicap. The existing strategy of planned, state-led industrialisation had already been in place for nearly forty years. This continuity implied a strong socio-political institutionalisation of the old planning strategy. Enough time had elapsed for coherent managerial elites to form in the public sector, along with unions representing relatively privileged public sector labour. In addition, the private sector that had grown up with the stimulus of protection and survived with aid of state sector credit had not been clamouring for economic liberalisation (Waterbury, 1992: 183-4; 187). Although some efforts of liberalisation had been made in the 1980s, they had had a very fragile political base, and Manmohan Singh's position was hardly more secure as the Finance Minister of a minority government led by the Congress Party, which had itself constructed the old economic order in the days

of its political dominance. Against this background, what has been achieved, though flawed, is nevertheless rather remarkable.

The fiscal and foreign exchange crisis of 1991 gave the liberalisation agenda a fresh opportunity. The initial position of the economy was that the foreign exchange reserves were extremely low, the country's international credit rating was low, inflation was high (12 per cent) and the current account deficit stood at \$9 billion, or 3 per cent of GDP and 40 per cent of exports (Casein et al., 1993). The fiscal deficit was deteriorating, although not unmanageable. From the perspective of reform sequencing, the unsustainable macroeconomic position meant that stabilisation was the need of the hour and was rightly given top priority. From the outset of the reform process, however, the economic reformers within the government voiced a clear commitment to two other policy objectives, market liberalisation and improved distribution (i.e. poverty reduction and increased equality of incomes). Outside the government, only a minority were persuaded as to the desirability of liberalisation and, for historical reasons already mentioned, there is a strong presence of interest groups that possess the potential to mobilise powerful opposition to pro-market reforms.

The central government's record of controlling its deficit has been mixed. The figures are set out in Table 1. They show that a strong start was made in deficit reduction, but that the process was allowed to go into partial reverse in 1993-4. By October 1993, the government's borrowing requirement had ballooned to even higher levels than in 1991 and the fiscal deficit rose to 7.5 per cent of GDP for 1993/94. This was a significant departure from the initial plans of fiscal control as an essential condition supporting the reform process. The government achieved 20 months of belt tightening, but relented in the 1993 budget in an attempt to draw the economy out of recession.

Table 1. India: Central Government Deficits, 1990-91 to 1995-96

<i>Type</i>	<i>90-91</i>	<i>91-92</i>	<i>92-93</i>	<i>93-94</i>	<i>94-95</i>	<i>95-96</i>
Revenue	3.5	2.6	2.6	4.1	3.6	3.4
Fiscal	8.3	5.9	5.7	7.5	6.5	5.9
Primary	4.3	1.6	1.3	2.9	1.8	1.1

Source: GOI Economic Survey data

Note: Revenue deficit = Revenue expenditures – revenues.

Fiscal deficit = Revenue deficit + net capital expenditures.

Primary fiscal deficit = Fiscal deficit – disinvestment receipts – gross interest payments.

Efforts to cut the budget deficit had met with social and political resistance. By 1991, subsidies had grown to be about 10 per cent of central government expenditure. The central government managed to prevent spending on subsidies from growing between 1991 and 1993, but it had not been able to make significant reductions. In particular, there had been strong public opposition to the removal of fertiliser subsidies. In July 1991, fertiliser prices were subject to a 40 per cent increase, but this was scaled back to 30 per cent. The controlled price of urea was actually reduced by 10 per cent. In June 1993, the government reintroduced a temporary subsidy on non-nitrogenous fertiliser as a result of pressure from farmers and industry and to cushion the impact of decontrol. The government was also forced to drop plans for immediate price decontrol of urea. Subsidies for fertiliser (as for basic foodstuffs) have maintained their share of GDP. The government has had more success in reducing budgetary support to the state-owned enterprises, and this has contributed to such contraction of the fiscal deficit that has been achieved.

The high precedence to be accorded to financial sector reform in the liberalisation activities of the structural adjustment project was acknowledged by the government when it commissioned the Narasimham Report in 1991. In its wake, moves to prepare the financial system for liberalisation have been made. In order to strengthen what was a very fragile banking structure, more adequate accounting standards and stricter measures of bank supervision and regulation have been established. At least Rs 57 billion in capital has been injected into state-owned banks to help them provide for previous bad debts. The size of the funds that banks must lend at a lower than market interest rate to the government has been reduced from 35 per cent of bank deposits to 25 per cent. The complex system of administered interest rates has been greatly simplified, only a few rates remaining regulated.

At the same time, government borrowing from banks and the Reserve Bank of India has increased rapidly. A combination of this, recession in 1996-7, high rates of interest, bank caution over the new accounting methods and the capital adequacy ratios has resulted in depressed lending to industry. Despite the

lower interest on government debt, banks still find its zero risk attractive. Overlooking the importance of adequately reducing government borrowing before financial liberalisation has led to a credit squeeze on the private sector. The government still appears keen to press ahead with reform in the financial sector. Cash reserve ratios are to be further reduced and the regulations, which limit competition between banks, are to be eased. However, with a continued high fiscal deficit, financial reform objectives will be difficult to achieve. The difficulty is that

“The inconsistency between tight monetary and loose fiscal policy could lead to spiralling fiscal deficits . . . Fiscal consolidation is now essential for the success of further interest rate liberalization” (Joshi and Little, 1996: 131).

There are also two political road blocks ahead that have not been tackled. One is defended by the recipients of directed credit at concessional interest rates, notably the better-off farmers and small-scale industrialists. Since recovery of these loans is very poor, they are often *de facto* transfers and hence highly prized. Apart from the recipients, local politicians also have a vested interest opposing change, since their ability to influence these credit allocation decisions is a way of buying future political support. There is also a major obstacle in the way of improving the general efficiency of the banking system. That is the bank unions, who are likely to fight all government measures designed to reduce the current over-staffing or introduce mechanisation.

The bank unions are but one example of a whole array of public sector unions that are opposed to job losses in their enterprises. Employment in the organised sector of the economy constitutes only 8.4 per cent of the total Indian labour force, and public sector employees accounted for 71 per cent of all employment in the organised sector in 1991. Thus they have privileged pay, status and conditions compared with the rest of the working population. But on average their productivity is lower than workers in the private organised sector. The arguments for the retrenchment of labour in the public sector are well known:

“Preserving existing unproductive jobs may in fact damage the interests of new entrants into the labour market. The jobless may be fewer with reform than without. Further, the money that is used to protect unproductive jobs could be gainfully used to create several times more jobs (Venkata Ratnam, 1997: 50).

Nevertheless, the government has stopped short of undertaking the labour market reforms that would make large public sector redundancies possible. No specific changes were planned to remove barriers that restricted labour mobility. Regulations that constrained adjustment of the workforce and placed limits on firms' ability to liquidate assets and close plants were not dismantled. The fact that financial liberalisation has not yet created a competitive credit market must be one factor in the government's unwillingness to proceed with labour market reform.

India's Eighth Five-Year Plan highlighted the need to address the problem of loss-making state-owned enterprises, and indeed this need had been had been the theme of a number of high-level official reports in the 1980s, from committees chaired by Mohd. Fazal (1980-2), L. K. Jha (1983-4) and Arjun Sengupta (1986). In the early 1990s, leaving aside the oil sector, three out of four state-owned enterprises were making losses. The method chosen to tackle the problem was restructuring or revitalising sick public sector enterprises by means of Memoranda of Understanding, which granted greater operational autonomy in exchange for a reduction in budgetary support. Non-viable enterprises were to be closed. The National Renewal Fund was set up with a corpus of Rs 20 billion to ensure that the costs of technical change and modernisation would be alleviated by the provision of safety nets, retraining and redeployment. The Sick Industrial Companies Act was amended in December 1991, and 40 chronically sick public sector enterprises have been referred to the Bureau for Industrial and Financial Reconstruction for rationalisation or closure. However, as of 1997, no closures had taken place (ibid: 52)).

The government has continued to deny any intention of retrenching public sector workers. The necessary changes to labour laws that still require all enterprises to obtain prior government approval for closure, lay-offs and retrenchments have not been undertaken. Steps were taken to strengthen the National Renewal Fund by the allocation in 1992-4 of an additional Rs 10 billion from World Bank IDA loans, plus some of the proceeds of disinvestment of public sector undertakings. But the Fund has been used mainly to pay some of the costs of voluntary retirements within the central public sector.

Table 2 Resources of Public Sector Enterprises, 1990-1 to 1993-4, percentage of total by source

	1990-1	1991-2	1992-3	1993-4
Budgetary support	27.1	23.5	17.9	13.8
Internal resources	38.2	40.8	44.0	40.4
Extra-budget resources	34.7	35.6	38.1	45.8
Total	100	100	100	100

Source: Adapted by the author from Venkata Ratnam, 1997: 53, Table 3.3.

Note: Totals do not always add to 100 due to rounding.

There was an initial awareness within the authorities of the importance of holding down budgetary support to the SOEs in order to help to reduce the fiscal deficit at a reasonably early stage of the reform process. This was right from the sequencing viewpoint, and it was also implemented successfully, as indicated in Table 2. The share of SOE resources derived from budgetary support fell markedly in the first three years of the reform period. This proportional fall reflected an actual cash fall in the relevant years.

Yet simultaneously there was also recognition of the importance of avoiding opposition from powerful trade unions and of calming anti-reform sentiments within the public. Since the SOEs were able to persuade the state-owned banks to take up the large unsubscribed portion of their public bond issues, and since government disinvestment rarely exceeded 20 per cent of the equity, there was little real pressure for change. The composition of the SOE boards and their management practices carried on much as before. Privatisation was not an explicit policy objective, although that has now changed with regard to the telecom industry. The virtual ban on compulsory redundancy remains in place as a tacit acknowledgement by the government of the strength of the public sector trade unions.

The severe balance of payments problem of 1991 was corrected rapidly, largely through an initial 19 per cent devaluation and a reduction in imports. This success paved the way for the start of trade and exchange rate reform. After a spell with a dual exchange rate, the 1993 budget made the rupee fully

convertible (which amounted to a further 9.2 per cent devaluation). There was a sharp reduction in import tariffs in a range of goods such as cars, televisions, refrigerators, air-conditioning, tea and coffee. The maximum tariff rate was cut from 110 per cent to 85 per cent. Trade reform has continued, with the peak tariff rate reducing from 85 to 65 per cent. More recently, in the 1997-8 budget, a peak rate of 40 per cent has been indicated, with an average of 22 per cent. But India still has relatively high levels of protection, and a variety of different tariff rates that encourage demarcation disputes. The negative effect of tariff reduction on customs revenue is now beginning to be felt. Customs revenue fell by 4.5 per cent between April and November 1997. Now, domestic entrepreneurs are complaining that they are being exposed to external competition too soon, particularly before reforms in the credit and labour markets have gone far enough to allow them to compete effectively. This may result in a political backlash.

Uncertainty about what will happen next must be a deterrent to both domestic and foreign investment. The reforms of the regulation of industry, which looked very dramatic because the previous licence-permit requirements were so extensive, are (and can only be) permissive in character. Greater private sector participation in industries once reserved for the public sector is now permitted. Foreign direct investment is now discouraged less than previously, allowing greater scope for expansion and diversification by foreign subsidiaries. All this is welcome, and necessary, but will not generate enough private investment in the right sectors on its own, while uncertainty continues to cloud the prospects of further trade and financial sector reforms.

Now the advent of the BJP and its allies to government brings forth a new scene, and new 'owners' to the economic reform project. Like most of the main Indian political parties, the BJP has declared itself in general terms to favour the liberalisation of the economy. But, as a nationalist party, it has made some hostile noises towards foreign investment, and is unhappy with some of the implications of India's membership of the World Trade Organisation. Its big business backers will expect a long transition towards the full blast of international competition. At the same time, the BJP may be more radical in tackling some of the vested interests in the public sector that the Congress and United Front governments were unwilling to touch. But these declared preferences may or may not get translated into action depending on

the whims of the BJP's assorted coalition partners: they, too, are part-owners of the project, and will have their say on if, and how, it is completed.

5 CONCLUSION: IMPLICATIONS AND ISSUES FOR THE FUTURE

The CPA perspective has various implications for an understanding of the Indian economic reforms. In the first place, it confirms the view that launching reforms that come later in the order of precedence *before* reforms that come earlier in the precedence order are consolidated does little to advance completion of the whole process. The “premature” reforms at best tend to run into the sands, and at worst can be positively damaging. In particular, failure to bring the budget deficit under control has a far-reaching effect on the sorts of liberalisation that are feasible. There is a sense, not altogether paradoxical, in which India has tried too much reform, rather than too little. It has tried too much of the wrong kind, temporally speaking, and not enough of the right kind.

Secondly, there has been a clear difference between the successful implementation of reforms that rest on a technical consensus, have low information requirements and involve few actors, like the de-regulation of private industry and investment, and others with the opposite features, such as the reform of state enterprises. The Indian experience amply confirms the view that there are “difficult” types of reform that can be blocked by veto coalitions.

Thirdly, there has been no attempt at the imaginative re-design of reforms when they have run into opposition. The reaction to opposition encountered has been to retreat partially to the pre-reform position, rather than to devise a form of temporary compensation that would allow the reform to proceed, but at a higher cost. This is seen clearly in the matter of the partial reinstatement of the fertiliser subsidies. The Indian tactics to date have been neither those of speed and stealth (‘the big bang’), nor those of slowness and consensus building (‘gradualism’). Instead, they have been a combination of slowness (‘a series of little bangs, not always in the right order’) and stealth. Since the resort to political action depends upon the degree of transparency of the political system, the government can baffle some opposition simply by increasing the opaqueness of its policies. Successive Indian governments since 1991 have advanced by stealth, but only when the opportunity to do so

seemed to offer itself (Jenkins, 1997). The disadvantage of such tactics is that they preclude the active rallying of support constituencies. The result is that the real alignment of political forces on either side becomes rather hard to detect, both by the combatants and by observers.

These tactics have brought what began in India as a broadly successful economic strategy, which since 1992-3 has raised the historic growth rate by two percentage points, down to a very slow pace of implementation. The interest of the CPA method is that it highlights the tactics of active management, not just to sustain the reform process –i.e. to prevent reversals of stabilisation and liberalisation – but to accelerate the pace of its implementation. The Rodrik (1990) view that a relaxed fiscal stance and deep reforms in one or two sectors would make the adjustment process politically sustainable over the longer run has proved correct in the Indian experience. The Indian reform project is still just about alive; it has never been officially declared defunct. However, it could have been, and could still be, moved forward by a larger injection of political imagination and tactical ingenuity.

The best prospect for achieving this is to devise schemes to compensate losers in ways that do not negate all the benefits of reform, but only reduce them initially. This was already being urged when India was starting its reform process (Mosley, Harrigan and Toye, 1991: I 120, 307). It is still being urged (Joshi and Little, 1996: 193-4). The reasons why government have not tried harder to fashion compensation schemes for losers in order to allow politically blocked reforms to go ahead remains one of the unsolved mysteries of the political economy of structural adjustment (Rodrik, 1996: 39).

The CPA method is a rational action paradigm. It has a clarity and a precision that makes it a useful framework for thinking about the problems of implementing a programme of economic reforms. However, is one valid objection to it that it is an overly rational approach? Does it require a degree of rationality that is unsuited to the actors of the real world, imperfect as they are and it is? Is the concept of the rational actor too utopian in practice?

It certainly takes an effort of the imagination to see a government as a rational actor. Although ideally all government actions are fully co-ordinated and government action is therefore unitary in character, in practice this is hardly ever true. Within any single Ministry, there is usually a struggle taking place

to control the policy agenda. Different government departments pursue objectives that conflict to some extent: for example, some want to spend, while others want to control expenditure. In federal countries, important conflicts of objectives are often found between central and provincial levels of government. Thus even within those areas where the government can exercise control, policies are at least partially inconsistent. Inter-level inconsistency is more pronounced in federations or confederations, like India, where the powers of different levels of government are constitutionally entrenched. Indeed, this fact has proved to be the stumbling block so far to aspirations to replace a number of existing Indian taxes with a value-added tax.

Policy consistency is thus hard for governments to achieve across all the bodies that in some sense constitute “government” at a point in time. Across time, and large institutional projects are bound to stretch out over time, inconsistency creeps in as personnel change, as ministers, prime ministers and governments come and go. Some grand projects are simply stopped in their tracks, and what survives is only phase one of a project that was never completed. Others evolve over time in ways that the original designers did not envisage, or would not have approved. It is easier to detect these abortions and elisions in the physical environment than in the institutional landscape, but they can be found there, too. It is hard to maintain the rationality of the structural adjustment project, when its original owners (if it was lucky enough to have any) disappear from the political scene, and are replaced by others who may have a different overall agenda to pursue.

Nevertheless, when all has been said on this theme, the fact that governments are not (and perhaps can never be) rational actors does not dispose of the need for a rational action paradigm in government. Those within governments who are economic reformers are in constant tension with others who are not, and their relative power rises and declines, giving rise to the external impression of a lack of policy consistency. The beleaguered economic reformers need to have their own understanding of rational action if their cause is to make progress. The method of critical path analysis is a tool at their disposal.

The issues that arise from this analysis for future policy are the following.

- 1) Is there a single order of precedence among reform policies that is generally valid, along the lines explored in section 2 above? If there is more than

one, what are the factors that create the need for a different order of precedence? Do they include the initial conditions of the economy and the precise content of the reform package? Is the order of precedence of reforms something that itself needs to be, or can be customised by country?

- 2) The idea of an order of precedence of reform policies can refer both to an overall sequence between, for example, macroeconomic stabilisation, financial liberalisation and trade liberalisation, and to sub-sequences within macro stabilisation, finance and trade. Does each sub-sequence have to be fully completed before the next sub-sequence can be started?
- 3) Can the concept of a “normal duration” for a reform activity be operationalised? How strong is the empirical backing for the claim that normal duration is a function of technical consensus, the amount of relevant detailed information and the number of institutional actors involved?
- 4) Have any countries already made use of a CPA-type method in planning their reform programme? If so, what was the outcome? Did the experiment include the use of partial compensation of opponents of critical reform activities? If so, what was the outcome?

While the India case study is helpful in raising and illustrating these issues, a number of comparative case studies across different regions and different types of economy would be needed in trying to resolve them.

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