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# **Toward a Political Economy Approach to Policy-based Lending**

**George Abonyi**

May 2002

ERD Working Paper No. 14

# TOWARD A POLITICAL ECONOMY APPROACH TO POLICY-BASED LENDING

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May 2002

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## **Foreword**

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## **Abstract**

The paper identifies a set of core concepts that reflect key "political economy" factors shaping the policy reform process that can assist in guiding the policy-based lending (PBL) design process. It discusses the recurring themes that constrain the effectiveness of PBL, reviews from a political economy perspective the PBL experience at the Asian Development Bank (ADB) and elsewhere, and identifies some outstanding conceptual issues that would have to be tackled in the future in order to increase the likelihood of effective implementation of PBLs and to strengthen the joint capacity of developing member countries (DMCs) and ADB to design more effective PBL initiatives. While the problems traditionally encountered in PBL are unlikely to be eliminated in view of the nature of policy issues and reform, their frequency and intensity may perhaps be reduced if the domestic political economy context will be given proper recognition and accommodation in the PBL design process. It is also imperative to have a longer-time perspective since policy reform involves a process of change whose time horizon is likely to extend far beyond that of a particular PBL program.

## I. INTRODUCTION AND OVERVIEW

### A. The Challenge

“Water fees, a new instrument proposed by ADB, may succeed in snapping the bones of Thai farmers already heavily in debt.”

“The RID [Royal Irrigation Department of the Royal Thai Government] and ADB advisers should understand the culture of water allocation in Thailand.”

“If the government has no choice but to follow the dictates of international monetary organizations...then maybe there is no need for a government. It’s as if we have no government left...[T]oday international monetary agencies decide and design everything for us....”

Quotes from farmers’ representatives, community leaders, and academics  
(*Bangkok Post* 2000)

Policy-based lending (PBL) in various forms<sup>1</sup> is of increasing importance for both developing economies and for ADB. Yet PBL initiatives are often not implemented as expected, and/or lead to unexpected consequences. Moreover, as the above quotes illustrate with respect to the Asian Development Bank’s (ADB) Agriculture Sector Program Loan in Thailand—ironically, a program that emphasized extensive general stakeholder consultations—they are often surrounded by controversy. Their role and effectiveness in facilitating policy adjustment and reform were questioned by borrowing governments, lending institutions, as well as by the very groups and communities that are often the intended beneficiaries of the policy reforms.

This paper forms part of a multifaceted assessment of experience with PBL in order to contribute to strengthening the operational capacity of ADB in policy-based lending (see also Evans 1999, ADB 1999, OED 2000, Bolt and Fujimura 2002). The central question implicit in this particular paper is: “Why do bad things happen to seemingly good ideas in PBL?” That is, why do PBL initiatives that more often than not embody good intentions, hard work, and apparently good ideas, often experience significant difficulties in the “real world of policy.”<sup>2,3</sup>

<sup>1</sup> Policy-based lending (PBL) refers to any initiative that is intended to support change, adjustment, or reform in policies, policy processes, or related institutions. The assumption here is that PBL initiatives, in whatever form, encounter similar basic sets of constraints, and can therefore benefit from similar types of concepts, frameworks, and methods aimed at strengthening their design. Within ADB, PBL initiatives may take the form of (i) program loans, (ii) sector development program loans, and (iii) projects that increasingly involve policy-related activities and/or de facto “policy conditionalities.”

<sup>2</sup> In order to assess the contribution of PBL to country performance, it is necessary to evaluate first its impact on policy reforms and improvements; and second, the impact of these reforms on country performance—admittedly a challenging task. However, in this context what can be concluded is that the fundamental issue is not compliance with conditionalities, but sustained policy reform and improvements over time. From this perspective, there is persuasive evidence that PBL in general has made limited contribution to policy reforms, and therefore to country performance. ADB’s experience is typical of the international financial institutions or IFIs (for a description of ADB’s experience, see OED 2000, ADB 1999, Evans 1999). On the World Bank experience, see for example, Collier (2000, 1999); and Dollar and Svensson (1998).

<sup>3</sup> A supplementary question that relates to the general scope of this paper but is not addressed as a specific issue is: What do we make of situations where conditionalities are not met in any real terms, yet related reforms are implemented effectively anyway?



Given PBL's intended role of supporting policy reform in order to improve country performance, it is not supposed to be like this. Taking the above example of water user fees in Thailand, conceptually, the use of the price mechanism for the optimal allocation of irrigation water, an increasingly scarce resource in Thailand, seems to make eminent sense and is consistent with both economic theory and "international best practice." As Williamson (1998, 1-2) notes: "Most economists tend to assume that most market-oriented reforms will benefit most of the people, including most of the poor, most of the time.... The case for such reforms often seems so overwhelming to us economists, on both efficiency and equity grounds, that we have trouble in comprehending why we need to argue the case rather than just identify what needs to be done. Yet the case does need arguing ...[because] ...reform may seem less compelling to politicians than it does to most economists."<sup>4</sup>

As the water user fees example illustrates, presenting the technical or economic rationale for "optimal policy reform" is not sufficient for establishing the case for undertaking a reform program, let alone to guarantee its successful implementation. First, the very concept of "optimal policy reform" is the subject of debate in the context of particular countries and policy issues. Second, how to effectively implement the usually extensive changes implicit in policy reform—the "transition process"—is generally not at all clear.<sup>5</sup> Both the appropriateness of particular policy reforms and the associated process of change are of central concern to relevant stakeholders. These include decision makers involved in key policy decisions and their implementation such as politicians; and intended beneficiaries, who must live with the consequences of such decisions. From this perspective, the technical or economic "optimality" of policies is not enough: they need to lead in particular country contexts to expected results, at the very least to sustained improved performance.

In this context, there is a tendency to group difficulties with PBL under the umbrella of "implementation problems." The implication is that the design of particular PBLs is generally fine; it is the messy implementation process that throws good ideas off track, e.g., "if it only were not for wavering government commitment; for "political games"; and institutional weaknesses." It is the finding of this paper that this perspective is misleading: design and implementation are intimately interconnected in a process of change. They cannot and should not be separated either conceptually or operationally in the PBL process. Difficulties of "government commitment", 'political games', and "institutional weaknesses" are usual characteristics of the policy reform process. As a consequence, the design of PBL initiatives should reflect an assessment and understanding of the policy reform environment *as is*, including implementation conditions, constraints, and requirements. From this perspective, issues such as institutional constraints on implementation are key needs to be identified and addressed at the PBL design stage, and monitored as policy reform and PBL implementation evolve.

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<sup>4</sup> It should be noted that Williamson (1998) presents a far more sophisticated picture of the policy reform context than implied by this particular quote.

<sup>5</sup> As Bruno (1985) notes: "...theory tells us virtually nothing about optimal transition paths from a distorted system to one that is more fully liberalized. Unfortunately, this is the most important problem for any successful reform." And this is before consideration of whether there is in fact an "optimal" transition path.

Generally, this paper suggests that basic and recurring problems associated with PBL go beyond “problems of implementation.” They arise because of characteristics of the policy environment: the “political economy”<sup>6</sup> context within which the design and implementation of PBL takes place compared with traditional investment project lending. These characteristics relate to the nature of policy issues, the policy process, and the implementation context. As a consequence, political economy considerations should be explicitly recognized from the outset, accommodated in PBL design, and monitored as implementation unfolds. This is more likely to reduce the gap between expected and actual results in policy reform and PBL. The types of problems are unlikely to be eliminated given the nature of policy issues and reform, but perhaps their frequency and intensity may be reduced.

## B. The Framework: Outline of the Paper

The basic purpose of this paper is to identify and/or formulate a set of concepts that reflect key “political economy” factors shaping policy reform and therefore PBL. A better appreciation of these concepts can help strengthen the *joint* capacity of DMCs and ADB in designing more effective PBL initiatives in supporting policy reforms. For PBL design to be effective, it should be *relevant* and *feasible*:

- (i) *Relevant* PBL is responsive to the particular characteristics of the policy issue or problem in a specific setting, in terms of the likelihood of contributing in well-defined and significant ways to improvements.
- (ii) *Feasible* PBL is one that is likely to be implemented in the actual circumstances in a particular setting (as distinct from an “optimal design” for an idealized set of conditions that may not fit the particular context of implementation).

The approach taken in this paper may be summarized as follows. PBL, as an element of policy reform, is essentially about *change*. The process of change and its outcomes are shaped by the *complexity* of policy issues, and associated *processes, people, and institutions*. The effectiveness of PBL depends fundamentally on a *mutual understanding* between DMC governments and ADB. This summary also reflects the organization of the paper.

Specifically, policy reform, and therefore PBL, basically involves *change*: transforming one set of policies and institutions to another in order to resolve a perceived problem and/or to help bring about improvements in socioeconomic conditions. This set of existing policies and institutions involve a particular distribution of benefits and power, which are in turn, based on an existing system of incentives, structures, and behaviors. Therefore PBL should be approached not as a technical exercise in “optimal policy design”, but as a complicated, long-term, and uncertain process of change that relates to the design, implementation, and sustainability of policy reform and associated transformations in incentives, behaviors, and institutions involving a time horizon that may extend far beyond the time frame of a particular PBL. This is the focus of Section IIA1.

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<sup>6</sup> Political economy context here refers broadly to the interrelationships between political and economic institutions and processes, particularly as related to policy decisions and reforms.

Policy reform and PBL as *strategy of change* involve tensions between two basic and potentially competing approaches, the focus of Section IIA2. One approach focuses on “international best practice” as the basis for PBL design. It begins from an assumption that the nature of policy problems and options for resolving such problems are relatively well understood. Donors often approach PBL design based on principles of “international best practice” built on experience with many countries in various situations, i.e., emphasis on “doing the right things.” A second approach begins from the assumption that policy problems and options for resolving them have fundamental characteristics that are unique to a particular setting. Government tends to focus on unique country characteristics and constraints as the basis for reform and PBL strategy, e.g., emphasis on “doing things right” in terms of country relevance and feasibility. Therefore policy reform—and PBL design—involves devising new rules for specific contexts. The challenge in PBL is to build on the two approaches and bring about desired changes.

The process of change involved with PBL and its outcomes are shaped by four key factors: the complexity of the policy issues, the process of policy making, people as stakeholders or “political players” in policy reform, and institutions involved in policy formulation and in implementation. Policy issues are *complex* in that they generally encompass many variables that are dynamically interrelated in ways that are not fully understood; involve multiple and conflicting interests; and combine a diversity of institutions that play varying and interdependent roles in the policy reform process. The nature and implications of the complexity of policy issues is discussed in Section IIB, with particular emphasis on the “complex structure” of the policy issue or problem and its implications for PBL, e.g., the role of policy conditionalities.

The focus of Section IIC is on the *policy process*: a set of interrelated decisions and/or activities by individuals, groups, and institutions involved in identifying and selecting courses of action to address particular policy issues. It is suggested here that an understanding of policy processes associated with particular PBL activities and conditionalities is an essential input into the design of effective PBL.

A key factor in policy reform and PBL is *people*—but from a particular perspective for the purposes of this paper. Policy reform is to a large extent political in nature. Therefore understanding the role of people as “*stakeholders*” or “*political players*” in the policy reform process is of particular interest and importance to the design and implementation of effective PBL. The assessment and accommodation of the political context on the proposed activities and conditionalities in PBL design are essential in order to ensure their successful implementation, the focus of Section IID.

Policy reforms and associated PBL activities and conditions are implemented through the decisions and actions of a set of interdependent *institutions*. Successful implementation requires a certain level of institutional “infrastructure” to be in place. The PBL process therefore must include an assessment of the relevant institutional capacity and its implications for PBL design and implementation—the focus of Section IIE.

Policy reform is primarily a “domestic game”, even if initiated by external factors: it is domestic conditions, requirements, preferences, and behaviors that shape the process and outcomes

of policy reform. Therefore, the effectiveness of PBL is ultimately a function of *mutual understanding* between domestic stakeholders and ADB; in particular the DMC government that must manage the process of domestic policy reform to which the PBL is intended to contribute; and ADB that provides external support to such reform in terms of financing, advice, and capacity building. Mutual understanding in PBL basically means shared expectations with respect to the nature and expected outcomes of PBL activities and conditionalities. This is the focus of Section IIF.

The concluding section of the paper (III) does not attempt to summarize the argument presented throughout the paper. Instead, it presents some very brief, and general observations on the implications of the political economy perspective for ADB's approach to PBL design. The annexes provide additional information and perspectives on selected issues.

## II. CORE CONCEPTS: THE POLITICAL ECONOMY OF PBL DESIGN

### A. Policy Reform as "Change": A Process Perspective on PBL

#### 1. Context: Beyond "With" and "Without" in PBL Design

Policy makers are generally aware of the difficulties brought about by changes inherent in a policy reform; it must be worth the effort. Therefore the rationale for policy reform and PBL should be convincing. At the very least, the need for and the expected benefits from change should be clearly reflected in the logic of PBL through a representation of the "with reform/PBL" situation as compared with the situation "without reform/PBL."<sup>7</sup> Despite the inherent problems in identifying the counterfactual this helps clarify the economic benefits foregone of continuing without policy reform (further discussed in Bolt and Fujimura 2002).

Identifying the benefits of reform using the with/without perspective can play an important role in establishing the economic rationale for change and PBL. However, this essentially comparative static formulation may not be sufficient for establishing the case for undertaking a particular program of policy reform or PBL. It does not reflect adequately *what* is being changed in the process of policy reform. On its own, this logic represents a general approach to policy reform and PBL that makes an implicit separation between "planning" and "doing." It does not indicate the potentially wide and extensive range of changes required and/or triggered by policy reform and PBL, beyond the technical dimensions of the particular policies and programs. Nor does it provide guidance as to *how* to effectively undertake the process of change. That is, by not reflecting the essence of policy reform and PBL as a process of change, it does not provide sufficient framework for designing a PBL with an increased likelihood of success.

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<sup>7</sup> See Evans (1999) for a discussion of the "with/without" approach to PBL design, suggestions for its implementation, and examples.

## 2. Change as Process

It is useful to clarify the nature of the change process involved in policy reform and PBL to identify the appropriate approach for PBL design. Launching reform or PBL is a bit like a “local earthquake”: it upsets not only the existing policy mix, but sets in motion over an extended time horizon, often unpredictable and unanticipated changes in structures, systems, processes, incentives, expectations, behaviors, relationships, power alignments, and institutions.

A decision by the executive branch of the government (e.g., Office of the President) to address particular policy issues and initiate policy reform, or by a central agency (e.g., Ministry of Finance) on PBL is usually just the beginning of the process. It generally then requires forging the necessary domestic consensus through a political process of formal and informal negotiations and bargaining within the framework of existing institutions. This process of “policy making” usually modifies to varying degrees—or at the limit, may block—policy reform and associated PBL initiatives. Subsequently, success and sustainability of policy reforms and PBL are shaped primarily during implementation. It is at this stage that conflict, resistance, “slippage”, and rejection of change become most apparent; and constraints on proposed policies become clearer. Policy reforms and PBL initiatives may be altered or reversed at any stage in their life cycle by the actions or resistance of stakeholders, including implementing institutions. Therefore, such reforms are unlikely to be implemented or sustained unless they create a coalition of beneficiaries. As a consequence, policies, and associated PBL initiatives may proceed as intended but may be blocked or modified to varying degrees, such that the final outcome is very different from that intended by policy makers (see for example Grindle and Thomas 1991, and Haggard and Kaufman 1992).

*Examples:* In the case of the Philippine Power Sector Restructuring Program Loan, the rationale for reform and associated benefits were the basis of legislation developed by the Philippine National Power Corporation, supported by an international panel of experts. However, the required legislation was stalled in the policy making (legislative) process, as was the associated Program Loan. In the case of Thailand’s Agricultural Sector Program Loan, the economic rationale for water user fees was clear. However, demonstrations by farmers’ groups blocked the proposed reforms, and stalled the associated Program Loan. In the case of the Lao Financial Sector Program Loan II (FPLII), a required Leasing Decree was eventually passed (after failing to pass under FPLI), but there is significant uncertainty about the institutional capacity to implement this decree.

*Example:* In the case of Thailand’s Agricultural Program Loan, proposed reforms (water user fees) were blocked prior to the formal policy process, well before implementation, by opposing farmers’ groups. In the case of the Philippine Power Sector Restructuring Program Loan, proposed reforms were blocked during the legislation stage by opposing interests. In Thailand’s Social Program Loan, the proposed decentralization of state-run schools was blocked at the implementation stage by opposing

teachers. In Sri Lanka's Agricultural Sector Program Loan that involved removal of fertilizers subsidies, a government was elected subsequently with the mandate to restore such subsidies.

In addition to political factors, policy reform and PBL generally require or involve extensive administrative, technical, and organizational changes. These relate to institutional capacities often in short supply in the countries undertaking such reforms (see for example Haggard and Kaufman 1992 for a discussion of this issue).

*Example:* Privatization of state-owned enterprises (SOEs) or state controlled banks calls for expertise in financial and organizational restructuring; rehabilitating enterprises; and preparing them for divestiture. It requires realigning internal incentive structures; establishing transparent and efficient procedures that guarantee the best price for the sale of public assets; and ensuring the existence of a sufficiently competitive or appropriate regulatory environment to ensure that efficiency gains are realized from privatization. It involves redefining industry or sector relationships with suppliers, customers, employees, and related institutions including relevant government and regulatory agencies.

Given the extensive and wide range of factors involved, the actual process and associated costs, time, and outcomes of policy reform and PBL are often quite different from what was planned or expected at their inception. Political and institutional constraints on implementation change the nature, content, timing, and scope of reforms. From this perspective, policy reform, and by extension PBL, have characteristics of an evolving "experiment" with uncertain trajectory and outcomes, rather than a "blueprint" whose actual path and associated consequence can be known at the outset with certainty.

*Example:* The Viet Nam Agricultural Sector Program Loan was deemed a success. However, this loan was implemented in the context of domestically initiated reforms that were well under way prior to the PBL. The design of the PBL, including associated conditionalities, was probably supportive of and consistent with the reform process. But there is a question as to whether or to what extent the PBL was necessary for such reforms (ADB 1999). In the case of the Lao financial sector, which was the recipient of the ADB Financial Program Loan I and II, a joint ADB and World Bank review in 2000 concluded that nominal financial sector reforms have contributed little to improving sector performance (ADB and World Bank 2000).

Against this backdrop, it is often difficult for governments to initiate or sustain policy reform over an extended time horizon.<sup>8</sup> It is therefore not unusual to find an increasing gap between

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<sup>8</sup> Perhaps with good reason: the experience with organizational change, for example in the US, a far more modest undertaking, is sobering. See for example Carr (1996) and Wilkins (1989).

announced intentions of government, and the actual policy choices and outcomes. The role of “government commitment” in PBL should be seen in this context.<sup>9</sup> To be effective, it is essential to ensure, to the extent possible, the relevance and feasibility of proposed measures. The PBL design, including the policy matrix and conditionalities, must reflect the specific realities of the policy making and implementation context in particular country settings, in terms of both feasibility and timing, if it is to support policy reform and lead to desired results.

### **a. Operational Implications for PBL Design**

A “process-based” perspective on policy reform has important operational implications for PBL design. In addition to a “comparative static” approach (“with/without”) that establishes the rationale and technical requirements of policy reform, a “dynamic dimension” must be introduced into PBL design. This involves posing the following general questions:

- (i) does the proposed PBL have a reasonable chance of being approved, implemented, and sustained; if not
- (ii) what are key constraints and their implications; and
- (iii) how can PBL be designed (or modified) or supplemented to increase probability of successfully approving, implementing and sustaining policy reforms.

In general, the greater the likely difficulty of policy reforms and associated changes, the more time and preparation are likely to be required for initiating and implementing PBL; the more resources are likely to be needed to support PBL implementation and manage the identified constraints; and the higher the uncertainty associated with expected outcomes.

To help in anticipating the level of difficulty of change, and to identify potential constraints on PBL, the following factors may be considered in PBL design:

### **b. Key Factors in PBL Design**

Changes will have greater likelihood of difficulty in the presence of the following:

- (i) characteristics of the policy issue, i.e., relative complexity of the policy issue in terms of the number of factors and interrelationships involved
- (ii) nature of the policy process, i.e., the more steps, institutions, and participants involved in approving or initiating reforms
- (iii) political dimension of the policy reforms involved, i.e., what is required to forge and maintain consensus.
- (iv) number of stakeholders (e.g., groups, institutions) involved, and/or intensity of differences among stakeholder preferences

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<sup>9</sup> See Annex 3 for a discussion of government commitment.

- (v) institutional requirements, i.e., how extensive are the required changes in processes, systems, procedures, incentives and cultures, including the number of agencies/institutions involved
- (vi) mutual understanding between ADB and government, i.e, the greater the gap between ADB and the government on the nature, role, scope, design, and expected outcomes of PBL, the more likely are the difficulties in sustaining the necessary government commitment

Before developing the above factors in subsequent sections, it is useful to look at alternative change strategies in policy reform and PBL.

### **3. Change Strategies: “Global Blueprints” and “Local Incrementalism”**

There are two general (if here somewhat idealized) approaches to policy reform as a “process of change.” One approach is “rule driven”, which focuses on changing formal rules first (e.g., emphasis on legislation, regulations), with the expectation that behavior will adjust. The second approach is “behavior pulled” and focuses on building up understanding, interest, and commitment to change in increments; then introducing basic “rule change” once there is a base for acceptance of change. The “rule driven” perspective emphasizes “doing the right things”, for example, putting priority on international best practice as the basis for the design of policy reform. The “behavior pulled” perspective emphasizes “doing things right” in terms of the requirements of implementation within the particular country context.

#### **a. Emphasis on “Doing the Right Things”**

This approach focuses on technical and formal policies, decrees, laws, and legislation. This may lead to a preference for a comprehensive approach to policy reform embodied in many, wide-ranging, and detailed policy conditionalities in PBL. It may also reflect an implicit separation of analysis and design, from implementation. The logic behind this strategy may be summarized as follows:

- (i) The functioning and structure of economies (including their political and social dimensions) are relatively well understood.
- (ii) There exists a menu of “international best practice” in the form of institutional, policy and program design experience, concepts, and approaches that can provide effective guidance for addressing a wide range of policy issues in a diversity of settings.
- (iii) Although these may be adjusted to take into account local conditions, it is the concept of “best practice” that drives the PBL process.

This approach may be selected because there is a judgment (which may or may not be based on detailed assessment) that policy issues in the particular DMC context are sufficiently congruent with general understanding and best practice. Alternatively, it may be chosen because



it provides a “shortcut” for designing PBL, especially given resource, time, and information constraints. Finally, there may be ideological reasons that involve a preference for a particular policy mix, even though it may involve a significantly greater change effort and associated uncertainty about outcomes, than a strategy that places greater emphasis on the feasibility of change, given initial conditions.<sup>10</sup>

### **b. Emphasis on “Doing Things Right”**

This approach emphasizes “doing things right” in terms of the implementability of policy reform in particular country settings. It focuses on ensuring that policy reform leads to actual improvements in country performance or quality of life; that changes are feasible and sustainable, if more modest, in the particular societal context. This may lead to a preference for an incremental approach to policy reform over an extended time horizon, embodied in fewer and more limited policy conditionalities in PBL. The logic behind this approach may be summarized as follows:

- (i) In a world of increasing complexity, uncertainty, diversity, and change, there are limits to our general understanding of the functioning of economies, including their political and social dimensions.
- (ii) We need not turn our backs on accumulated knowledge of how economies work, including “international best practice”, but policy reform must ultimately be anchored in the realities of particular economies (societies), if change is to be successful, and the desired results to materialize.
- (iii) Although “best practice” can have an important role to play, it is the feasibility of policy reforms in particular settings that must guide the PBL process.

This approach may be selected because there is a judgment that the particular country context and circumstances are not sufficiently well understood to embark on a comprehensive program of reforms. It is also posited that the particular nature of the policy issue and its country context may differ in significant ways from general knowledge, and therefore should not be approached primarily on the basis of general theory and “international best practice.” Finally, there may be an expectation of significant political and institutional constraints on policy reform, and hence a more limited and incremental approach is judged as more likely to lead to change.

### **c. DMC Perspective**

There is a perception that donors often attribute unrealistic capabilities to governments in the policy reform process. As a consequence, donors are perceived to prefer that a comprehensive package of reforms be introduced, which according to the lessons learned elsewhere might prove sufficient to bring about quick change. The implicit assumption is that the government is robust and strong enough to maintain political stability necessary, and that the institutional capability

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<sup>10</sup> See Annex 2 on institutional change and market-oriented reforms.

is or can be put in place, to carry out the whole reform package quickly. The focus is then on obtaining “government commitment” to reform, which is generally identified with the key central agency counterpart, e.g., MOF.

*Example:* Viet Nam is a multilevel society in transition, made up of many stakeholders with respect to policy reform: ministries, SOEs, party, provinces, communities. Understanding and consensus needs to be built up at each level for policy reform to proceed and be sustainable. This takes time (and resources). Furthermore, in Viet Nam transition means that many things are changing simultaneously, extensively, and unevenly—and may involve the same “actors” but in different roles. This means that in the design of PBL, many factors and relationships beyond the scope of PBL need to be taken into account for some of the conditions to be feasible, i.e., there needs to be an understanding of the feasibility of the conditions within the broader context of policy reform. In this environment, beginning more modestly (e.g., pilot projects) may be more effective in creating the necessary conditions for successful change.

An effective strategy of policy reform and PBL should ideally draw on both general approaches identified: it should involve both “doing the right things” and “doing things right.” In an environment of limited knowledge, uncertainty, change, and diversity, PBL design should not be constrained by the rigid application of general rules, or “international best practice” that may not fit particular settings. At the same time, given accumulated knowledge and experience, neither should policy reform start from scratch. In particular, “international best practice” can provide guidelines for PBL design, but measured against particular country context. Where such “best practice” guidelines do not fit, appropriate policy initiatives will need to be devised based on the characteristics of the specific policy issues and particular country context, but perhaps reflecting accepted general principles, e.g., role of markets. An important role of ADB is to ensure that the implementation requirements of key PBL conditionalities are fully considered in the process of PBL design, by identifying potential gaps and constraints to feasibility. The key factors identified earlier as the basis for anticipating potential constraints in the policy reform and PBL process provide a general framework for such analysis. The individual elements of the framework will be developed further in subsequent sections of this paper.

#### **4. A Note on Crisis vs. Noncrisis Conditions: Implications for PBL**

There are important differences in PBL under “crisis” and “noncrisis” conditions. However, from a “process perspective”, the core issues for effective PBL are similar. Crisis can create opportunities and pressures for policy change. However, although it may provide an opening, crisis conditions may also make it difficult to lay the foundations for the sustainability of reforms once the immediate pressures of the crisis subside.

A certain level of societal readiness is necessary for policy reform and PBL. Unless there is sufficient broad-based support, policy reform is not likely to be implementable or sustainable. Therefore, a key challenge is to ensure that reforms introduced under crisis conditions are sustained

beyond the crisis. Crisis conditions may therefore be used to initiate PBL, but it is important to ensure that the associated reforms would likely to “stick” beyond the crisis. The difficulties involved often show up as “second tranche conditions”, when the urgency of the reforms or of the financial constraint is less, and therefore the commitment to change decreases.

## **B. Complexity: A Defining Characteristic of Policy Issues**

In addition to constraints arising from the characteristics of the change process, difficulties and uncertainties with policy reform and PBL also arise from the complex nature of the policy issues themselves.<sup>11</sup> Complexity, at one level, relates to the political nature of policy issues, involving multiple stakeholders with differing perceptions and preferences. It also relates to the diversity of institutions that play varying and interdependent roles in the policy process. This section touches on another dimension of complexity as it relates to the structure of policy issues: that policy issues involve many elements and interconnections (“feedbacks”) among these elements through which change (reforms) may be transmitted or cancelled out. There are typically various leverage points—some of which may not be readily apparent—where PBL activities may focus in order to help bring about desired reforms. Furthermore, there are generally strong interconnections among different policy issues; making it difficult and somewhat arbitrary to define boundaries as to what should be part of the PBL and the basis of conditionalities; and what may be ignored in PBL design. The complexity of policy issues therefore relates to both their structure and boundaries.

*Example of complex boundaries:* To undertake reforms and associated PBL conditionalities related to the privatization or “corporatization of SOEs” (e.g., one of the key initiatives listed in the Viet Nam SOE PBL) relates to factors such as legal, financial and accounting frameworks; administrative procedures; technical and managerial skills; changes in organizational culture; changes in the nature of the relationships between the SOEs and suppliers, customers, competitors, and government regulators etc. All of these are part of the “means/ends chain” necessary for the implementation of the desired reforms. However, it may not be feasible to include all of these required activities in a PBL, and/or some may already be part of other policy reforms (e.g., reform of the financial sector).

Given the complex nature of policy issues, there is generally limited knowledge and significant uncertainty about such issues; in particular, about means/ends relationships in PBL design and associated conditionalities. In practice, this may be reflected in weak logical linkages in PBL design between the policy issues being addressed, core PBL activities and associated conditionalities, and desired results. In this context, complexity may lead to two types of errors in PBL design: errors of omission, i.e., leaving out key aspects of the policy issue whose relevance

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<sup>11</sup> See Annex 1 for further discussion of the nature of the complexity of policy issues, and its implications.

is not understood, but that should be included as a focus of PBL in order to bring about desired results; and errors of commission, i.e., including in PBL design aspects of the policy issue—and associated conditionalities—that are not essential for the desired results of policy reform.

*Example:* An example of an “error of commission” is the Leasing Decree initiated under the Lao Financial Sector Program Loan I and eventually passed under Program Loan II after a long and difficult process. The relevance of a complicated decree to improve the performance of the financial sector, and more generally country economic performance is questionable, especially in light of constraints on institutional capacity to implement the decree, and where 80 percent of the economy is estimated to be in the informal sector.

More generally, how a policy issue is posed or structured plays a significant role in shaping the approach that will be taken in attempting to respond to it. This “model” of the issue, however informal or implicit, will direct attention to certain characteristics or elements of the policy environment, and frame the policy issue in a particular way.

*Example:* In the case of the Viet Nam State Owned Enterprise (SOE) Program Loan, the broad objective is to contribute to employment and income generation through a focus on “corporatization” of a relatively small number of large SOEs—whose overall employment share is relatively limited. Originally, considerations of PBL design started along quite different lines, as the “Enterprise Development Program Loan”, providing a much wider scope for defining program design. This could have led to a very different PBL design in terms of employment and income generation. For example, the PBL could have focused on removing impediments to domestic private sector development arising from the large number of SOEs, most of which are relatively small in size, and therefore are outside the scope of the present program. This could have involved a PBL focused on strengthening the capacity of the government to divest small SOEs—perhaps more easily and quickly implemented, given past experience with liberalization programs aimed at large SOEs.

Constraints on PBL design arising from the complexity of policy issues, or more accurately, how well this complexity is reflected in PBL design, may become apparent as difficulties in implementing particular conditionalities, or as desired results do not materialize even when conditionalities are complied with. The second type of problem often reflects the mismatch between PBL design and the structure of policy issues clearly, since it involves conditionalities being met, yet does not lead to reform.

From this perspective, PBL conditionalities link or “intermediate” the policy issue and desired results, thus defining the operational focus of PBL. They simplify the complexity of the policy issues and specify key actions to be taken that are expected to contribute significantly to reform. The policy matrix (often consisting of extensive and detailed conditionalities, usually to be done in a very short period of time) in effect says: “If you implement the conditionalities

as written, you will address key elements of the policy issue that need to be changed, and the result will be a clear improvement in performance or quality of life.”

In this context, PBL conditionalities implicitly assume a great deal of knowledge about the policy issue; about effective actions for bringing about associated reforms and their desired results. As conditionalities increase in number and detail, so does the assumed knowledge about the policy problem, its context, and feasible means for its effective resolution. In an environment of complexity and uncertainty, care should be taken in including too many conditionalities, excessive details, and inflexibility. An “over-design” of PBL without adequate consideration of the logical basis of each individual conditionality in specific aspects of the policy issue, and in terms of the desired results implementation it is expected to generate, has generally not proven to be the most effective means for PBL to support implementable and sustainable reform.<sup>12</sup>

*Example:* The Philippine Capital Market Development Program Loan, terminated after the first tranche, had 44 policy reform activities, including the requirement for a Securities Regulation Code that had 18 sections. The Thai Agricultural Program Loan has 32 conditionalities, including three involving legislation.

From a methodological perspective, the Program Framework matrix is intended to provide the logical basis for PBL design, in particular for the policy matrix and associated conditionalities. However, in practice, Program Frameworks are often not very effective in representing the complexity of the policy issue and its context, and therefore provide limited guidance for the policy matrix. For example, they generally focus on the PBL, as distinct from representing the structure of the policy issue as the logical basis for PBL design. Furthermore, the Program Frameworks often mix input targets (“government commits to allocate more resources for school dropouts”); process milestones (“establishment of a consultative mechanism to prepare a new securities legislation”); output targets (“number of SOEs to be corporatized”); and impact targets (“increased foreign direct investment inflows”). Therefore, the usual application of a Program Framework and its transformation into a policy matrix is generally of limited help in identifying the structural basis for PBL conditionalities, and for appropriate sequencing of activities. It is essential to make explicit the assumed logical relationship between the policy context and PBL, to ensure that conditionalities are anchored in and responsive to key elements of the policy issue, and are clearly linked to the expected outcomes of policy reforms. This can also provide a clear, common frame of reference for discussion among stakeholders, including ADB and the government.<sup>13</sup>

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<sup>12</sup> See also Annex 2 for a discussion of conditionalities from this perspective.

<sup>13</sup> The class of methods called “structural models” can provide useful support for representing the complexity of the policy reform context, and the role and implications of PBL in general, and conditionalities in particular. This includes methods such as problem trees, objective trees, means ends trees, and intent structures. See Annex 3-5 in *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grants to the Socialist Republic of Viet Nam for the State Owned Enterprise Reform and Corporate Governance Program, November 1999* for an application of problem tree and objective tree analysis to PBL. See also Jackson (1998) for a brief introduction.

More fundamentally, it is essential not to lose sight of the basic intent of PBL in the numbers and details of conditionalities. The purpose of PBL is not formal compliance with a large set of detailed conditionalities whose relevance and/or feasibility may be uncertain, rather, contribution to policy reform. The following questions can be asked with respect to relevance of each proposed conditionality:

- (i) What is the logical relationship between this specific conditionality and particular elements of the policy issue to which it is supposed to respond, or specific problems it is intended to help resolve? What is its relevance/importance in terms of rationale for policy reform?
- (ii) What is the logical relationship between this specific conditionality and particular expected outcomes, and in what particular ways do these outcomes contribute to the broader purpose and desired results of the policy reform?
- (iii) What specific difference would it make to the desired results of policy reform if this particular conditionality were left out of the policy matrix? Is the difference significant in terms of the purpose of the reforms?

## C. Policy Making Process: From Design to Implementation

### 1. Context: Setting the Stage for Policy Reform and PBL

Initiating, approving, and launching a particular program of reform or PBL involve a set of interrelated decisions and associated activities by a network of institutions and roles, constituting the relevant *policy making process*. This process shapes the “production of policy” in practice: how policy is made, how it is reviewed and modified, how it is initiated. The policy making process determines whether a policy issue is deemed sufficiently important or urgent to warrant attention, i.e., is on the “policy agenda”; how it is defined, i.e., what aspects of it are deemed particularly important to be the focus of programs of action; what should be the nature of the reforms or programs of action; what resources will be allocated to reforms and when; and initiation of the reform process and its implications for implementation.

Policy making involves multiple players (groups, institutions), a sequence of stages or steps, and a set of associated decisions and actions. There are generally many organizations and agencies at various levels involved with the preparation and launching of initiatives related to PBL and its conditionalities. And what happens in practice can often be quite different than the formal system on paper. The actual policy making process can constrain the policy options available to individual policy makers, e.g., executive and government or central agencies such as MOF. For example, it may be the case that irrespective of the intentions or commitments of “the government”, meaning the executive, a central agency such as the Ministry of Finance, or a line agency such as the Ministry of Agriculture, a required legislation or decree may be difficult to pass, at least in the required PBL time frame. Alternatively, a decree may be easy to approve

but difficult to implement since the process of policy making does not provide sufficient basis for building the necessary consensus to support implementation.<sup>14</sup>

An appreciation of the policy making process and its implications are often not considered or accommodated in PBL design. In this context, the issue that may be posed is should time and effort be taken to understand and reflect on the domestic DMC policy making processes in PBL design? Or it is really up to “the government”, for example, the signatory agency such as the Ministry of Finance, to take care of such domestic matters once agreement on PBL is in place? The lessons from experience seem to indicate that PBL design should indeed reflect an appreciation of the actual government system and policy making process, formal and informal, in particular as related to PBL conditionalities in order to ensure that they are feasible and likely to be implemented. Without such appreciation there is a high likelihood that PBL will not proceed as expected.

*Example:* In the case of the Philippines, both the Capital Market Development Program Loan and the Power Sector Restructuring Program Loan ran into problems because key legislation did not proceed as required and expected. In both cases, there seemed to be awareness of the complex legislative environment, yet the PBL design assumed that the policy making process will be able to generate the required legislation within the stipulated time horizon.

*Example:* In the Thai Agricultural Program Loan, a number of key roles and relationships had to be considered, including the Ministry of Finance, Ministry of Agriculture and Cooperatives, National Economic and Social Development Board, and Office of the Prime Minister; the relationship between the political and technocratic levels; and the internal decision making process on resource allocation and its implications for PBL implementation. For example, given required extensive institutional changes and activities involving significant resources, an important consideration relates to the domestic budgeting process—how and if necessary funds are allocated for PBL implementation; and of the different actors involved in this process (i.e., relationship between policy making and budgeting).<sup>15</sup>

*Example:* In Viet Nam, as noted, policy making is a “multi-level, multi-player” process involving central agencies, line ministries, provinces, communities, and the Communist Party. The formulation of implementable policies requires building consensus for policy change in all these levels and institutions: it requires the “buying in” of multiple ministries and agencies. This takes time and resources, negotiations and bargaining. Furthermore, key elements of the policy process are in transition, e.g., legal framework, and will take time before stabilizing. Therefore the role of a central agency such as the State Bank of Viet Nam should be understood in this broader context of the policy process. The Government of Viet Nam is composed of

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<sup>14</sup> In this, the policy making process is closely linked to the politics of policy reform, the focus of the following Section IID.

<sup>15</sup> Based on interviews with ADB staff and officials of the Royal Thai Government. It should be noted that this PBL was linked to the Asian crisis, with a presumed emphasis on speed of disbursement.

differentiated interests that must reach an accommodation within the framework of the formal and informal policy making process on the nature, role and design of PBL.<sup>16</sup>

*Example:* In Lao PDR a core conditionality in LFPLII was related to bankruptcy rules and regulations. Originally, this was formulated as a requirement for Bankruptcy Legislation. After discussions with the government, this was changed to a Bankruptcy Decree that needed only prime ministerial signature. However, obtaining the required signature turned out to be far more difficult and time-consuming than anticipated, and was not yet in place at the time of the interviews for this paper (late 2000).

## 2. Incorporating Policy Making into PBL Design

As suggested by the examples, an understanding of the policy making process would seem to be useful and essential for the design of effective PBL. A better appreciation of the policy-making context, including how the process can constrain or modify the reform program, e.g., steps and time to pass required legislation, is necessary in order to assess the feasibility of each proposed PBL initiatives and respective conditionalities. Analysis of the policy making process associated with each specific reform initiative or conditionality can help identify key issues and constraints that may then be reflected in PBL design, e.g., as modifications to conditionalities, or as additional supporting activities such as technical assistance for institutional capacity building, which are related to the policy process.

Furthermore, identifying the key elements of the policy making process associated with program activities or conditionalities can also provide a tool for assisting in the management of PBL beyond signing. It can provide a framework for monitoring key steps involved in the preparation, approval, and initiation of required decisions or actions, e.g., legislation. This can assist in focusing attention, and identifying or anticipating where “bottlenecks” are most likely to arise, requiring additional attention or resources, or possible changes in the PBL design and conditionalities, as the PBL evolves.

A focus on policy process does not necessarily imply a conservative position on policy reform. For example, conditionalities may be included that are known to be difficult to meet, for example, legislation, as a way of inducing policy changes that otherwise might not take place. However, a better understanding of actual policy processes (together with an assessment of the “political” and “institutional” context to be addressed later) can help identify the “critical success factors”—key decisions; by whom; when; needed complementary support—essential for bringing about desired reforms. This can contribute to a more realistic assessment of the likely success of the PBL inducing such reforms and perhaps the basis for “contingencies” in PBL design.

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<sup>16</sup> Based on interviews with ADB staff and officials of the Viet Nam Government. The political dimension of policy reform and PBL is discussed in Section IIE; the focus here is on the policy making process as a whole.



### a. Operational Implications for PBL Design

Understanding policy processes associated with PBL involves two aspects. At one level, it involves an understanding of the general government structure, system, and functions related to policies and decisions for a broad policy area. This provides a useful backdrop for PBL design.

*Example:* Policy reform related to agriculture sector in Thailand, in general, is likely to involve, among others, the Ministry of Agriculture and Cooperatives as the key line agency; the Ministry of Finance; Bureau of the Budget; National Economic and Social Development Board, Office of the Prime Minister as overseer of the development strategy; Ministry of Commerce on matters such as tariffs; Cabinet and relevant Subcommittees (e.g., Cabinet Committee on Economic Restructuring and Competitiveness); and for legislation, Parliament. In addition, there are likely to be informal steps and channels involving other stakeholders such as industry associations, community-based groups, etc., to let their views be known and therefore influence the policy making process. An understanding of this general context provides useful background information for the design of PBL supporting policy reform in agriculture.

Each initiative or conditionality (e.g., removing subsidies on fertilizers; instituting water user fees) is likely to involve particular policy and decision making processes, and associated activities. These “conditionality-specific” processes also need to be understood in terms of their implications for PBL.

In this context, a process is a set of linked activities (e.g., decisions, actions) that takes an input or decision and transforms it to create specific outputs.<sup>17</sup> A “policy process” is simply a set of linked activities that result in a particular policy output (e.g., bankruptcy decree or legislation; policy to remove fertilizer subsidies). Understanding the actual policy processes related to particular PBL initiatives or conditionalities involves identifying:

### b. Policy Process Checklist

- (i) *Key decisions or actions required:* necessary inputs for the decisions or actions
- (ii) *Actors:* institutions, groups, their roles
- (iii) *Sequence:* relationship among decisions/actions and associated institutions/roles
- (iv) *Time frame:* time horizon associated with each component decision/action and with the policy process as a whole
- (v) *Potential constraints that could have significant impact on the process:* timing, content, etc. of key decisions/actions; factors likely to determine whether constraints materialize

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<sup>17</sup> Outputs, in turn, lead to outcomes or impacts. For example, a policy output in the form of a decision to remove fertilizer subsidies leads to particular outcomes related to the price of fertilizer, availability, use, etc.

This information, which may be summarized in a “policy process map”,<sup>18</sup> provides important inputs to the design of effective PBL. It allows the identification of a kind of “critical path” of the policy process (e.g., critical steps, institutions, time frame), which will affect the approval, content, and initiation of PBL. This may also be used to assess the feasibility of proposed PBL initiatives and conditionalities, and their timing, to identify additional necessary supporting activities and resources to be included in the PBL design.

#### **D. Politics of Policy Reform: “Political Acceptability” of PBL**

##### **1. Context: Politics and PBL**

Policy reforms and PBL involve changing the existing set of policies and associated distribution of benefits, costs, and power alignments. Policy reforms and PBL are likely to threaten interests associated with the existing system. That is, there are likely to be stakeholders who perceive themselves as “losers” from reform, and are likely to resist change. Furthermore, different formulations of reform programs and PBL are likely to involve different distributions of associated benefits, costs, power relations, and interests. As a consequence, proposed policy reforms and associated PBL initiatives may be blocked or changed during the policy making process. The role of politics in blocking/changing PBL has been noted earlier in the example of the Thai Agricultural Program Loan (related to water use fees), the Philippine Power Sector Restructuring Program Loan (related to the Electricity Industry Reform Bill), and the Sri Lanka Agricultural Sector Program Loan (related to removal of fertilizers subsidies).

Resistance to reforms often becomes most pronounced during implementation, as their likely consequences—including threats to associated interests—become increasingly clearer. Thus, policy reforms and PBL initiatives may be altered or reversed at any stage in their life cycle by the actions or resistance of stakeholders, including implementing institutions. Without sufficient and continuing support from key stakeholders whose cooperation is essential, policy reform and PBL initiatives are unlikely to be implemented and/or sustained. Examples noted earlier include the opposition of teachers to decentralization of state-controlled schools related to Thailand’s Social Sector Program Loan; the apparent lack of support in Viet Nam of large SOEs of proposed reform programs; and the election of a government in Sri Lanka with a mandate to reverse the removal of fertilizer subsidies, included originally in the agricultural sector reform program.

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<sup>18</sup> There is a range of methods that have been developed for representing processes and have been applied extensively to a wide range of organizational and institutional design efforts, most recently in the context of “business process reengineering” (BPR). The logic of “process maps” in general, including BPR, may be adapted with some modification to mapping policy processes in the context of PBL. See for example, El Consejero (1999) and El Sawy (2001).

## 2. Political Nature of PBL

Policy reform and PBL are to a large extent political in nature. That is, there exist multiple and conflicting interests with respect to given policy issues and/or proposed reform programs, and there is no easy way to align diverse and conflicting preferences. Policy reform therefore generally does not involve a single decision maker, e.g., “Government”, with well-defined objectives; making independent decisions; and the power to control the policy environment and therefore approval, initiation, and implementation of the reform process. It generally involves a process of negotiation, bargaining, and consensus building among diverse stakeholders with differing perceptions, preferences, and power. Policy reform is therefore generally characterized by a political process of mutual adjustment that shapes and often modifies both reform programs and associated PBL.<sup>19</sup>

Given the political nature of policy reform, PBL is, in effect, inserted into a domestic political “game.” Unless the specific political context of PBL is understood, PBL design may include conditionalities that are unrealistic in terms of what the government can actually do in an environment of differing and conflicting interests and limited control.<sup>20</sup> Therefore understanding the “political acceptability” of proposed PBL conditionalities is essential in order to assess their feasibility. In this context, “technical analysis”, e.g., economic rationale for removing fertilizer subsidies or instituting water user fees, whether domestic or donor-supported, is just one key input among others in a wider process of negotiation and bargaining. Whatever its technical or economic merits, if PBL is not politically acceptable, it will be difficult to implement and/or sustain. Governments generally need to have a level of confidence wherein reforms and associated PBL conditionalities are likely to be able to command the minimum necessary political consensus to be implementable.

*Example:* In the case of agricultural sector program loans in Bangladesh and Sri Lanka, both governments indicated that a phased reduction of subsidies was possible—but not outright abolishment. Bangladesh officials indicated that completely removing fertilizer subsidies was highly unlikely, and was likely to be further complicated by what may be seen as external pressure. As noted earlier, in the case of Sri Lanka, a new government was later elected with a mandate to restore fertilizer subsidies.

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<sup>19</sup> The usual “political economy” approach stresses that political constraints on reform arise in part because of the existence of clear and concentrated losers who have the incentive and means to organize to block reform. By contrast, beneficiaries of reform, even if potentially far more numerous, are seen as diffused and unorganized, and therefore less able to play a role. See for example, Haggard and Kaufman (1992) for a discussion of this issue. From the perspective of this paper the key point is simply that the politics of policy reform is a key factor in PBL, and as such, requires explicit attention.

<sup>20</sup> This in turn, could also weaken the government’s ability to introduce the needed reforms at a later stage under more appropriate conditions, by undercutting the credibility of the needed reforms and/or the ability of the government to implement them.

An important aspect of the political context of PBL relates to “bureaucratic politics.” Government is not a unitary actor; it is composed of multiple agencies with differing perspectives, interests, and incentives. The Ministry of Finance may sign off on the PBL and the associated policy matrix, however, it is rarely the agency responsible for implementing the required reforms and conditionalities. It may be line agencies, state enterprises, or even different levels of government (e.g., provincial, municipal) that must “own” the policy matrix and implement particular conditionalities. Yet these institutions may have little incentive to “own” the policy matrix, especially if they have limited access to resources from the PBL, which may go to the general budget. Therefore even if the MOF signs off on the PBL and “commits” to policy reforms and conditionalities, it may not be able to ensure compliance or implementation by relevant line agencies or different levels of government. Conceptually, in the design of PBL, government should be seen as a “multiplayer bureaucratic game”, characterized by problems of aligning incentives and coordination. In the case of Thailand’s Social Program Loan, the Ministry of Finance signed off and “committed” to the conditions of the program. Yet it could not ensure that the Ministry of Education and the Ministry of Health implement key conditions, e.g., relating to decentralization.

A formal commitment by “the government” or Ministry of Finance, however genuine, may not be sufficient to ensure the implementation of required PBL initiatives and conditionalities. There may be constraints on the capacity of “the government”, to deliver on such commitments within the framework of the domestic policy and political process. Therefore, PBL design requires an appreciation of what “the government” can realistically do over the relevant time horizon.<sup>21</sup> As noted earlier, the commitment of the Government of the Philippines, meaning the executive branch, was not sufficient to ensure the passage of required Securities Regulation Code for the Capital Market Development Program Loan; nor the Electricity Industry Reform Bill necessary for the Power Sector Restructuring Program Loan.

Any conditionality supporting reform is likely to create “winners” and “losers.” Furthermore, difficult conditionalities may be introduced deliberately, e.g., by “reformers” in the government in coalition with external partners such as ADB, to bring about policy changes that otherwise might not take place. However, a better appreciation of the political context of PBL conditionalities can help identify the likelihood and nature of political constraints on proposed initiatives, as well as options for and the likelihood of achieving a consensus. Consultations with key stakeholders and their involvement in the PBL design process—a time-consuming, complex, intensive, and not fully predictable task—may be essential both to ensure the relevance of PBL conditionalities, and for achieving consensus.

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<sup>21</sup> See Annex 3 for a broader discussion of “government commitment.” In this context, in the interviews it was also suggested that without sufficient political consensus in place, or the time to build it, pushing conditionalities too hard may be counterproductive, potentially retarding reform by galvanizing and strengthening opposition.

### 3. Operational Implications for PBL Design

In an environment of potentially considerable differences among stakeholders, it may not be wise to proceed with a PBL design that assumes consensus. Assessment of the political context of PBL involves identifying key stakeholders and their likely positions on specific PBL initiatives and conditionalities and includes the following points.

#### a. Political Assessment Checklist

- (i) What are the real boundaries of the proposed PBL as implied by key inputs, core activities, and associated outcomes?
- (ii) Given the above, who are the key stakeholders with an interest in the given PBL, or who will be affected by and/or are likely to affect the proposed PBL in terms of its inputs, core activities, outputs, or outcomes?
- (iii) What must be assumed about the behavior and preferences of each key stakeholder in order for the PBL to be successfully approved, initiated, implemented, and to lead to the desired outcomes?
- (iv) What specific elements of PBL are likely to lead to resistance or conflict, or result in perceived decreases in net benefits by particular stakeholders?
- (v) Do these stakeholders have the power and means to influence—at the limit block—the PBL process (approval, initiation, implementation) either individually or in coalitions?
- (vi) If yes, do the stakeholders have (or under what conditions would they have) the incentive to do so?
- (vii) How can PBL design be modified to account for differing needs and preferences not presently accommodated, while ensuring the basic contribution of PBL to policy reform?

An important means for incorporating political feasibility of proposed reforms and conditionalities into PBL design is through a process of stakeholder consultation. In this context, the strategy of consultation should be considered carefully. Two basic strategies may be followed: general consultations on broad issues related to policy reform and PBL design; and consultations on specific PBL initiatives and associated conditionalities.

- (i) The more *general* the focus of stakeholder consultations, the easier it is likely to be to reach consensus, and the less time is likely to be needed. However, the risk is greater for differences to emerge as the details of PBL initiatives and conditionalities are made known during the policy making process and implementation.
- (ii) The more *specific* the focus of stakeholder consultations, the more difficult it may be to reach consensus, and the more time is likely to be needed. However, once

such consensus is reached, there is likely to be less risk of differences emerging later during the policy making process and implementation.

*Example:* In Thailand's Agricultural Sector Program Loan, considerable time and effort was taken in stakeholder consultations on general issues related to PBL design. There was a perception that the consultations were successful and that sufficient consensus existed for the PBL. Yet as the PBL moved through the policy process, considerable opposition emerged, seemingly from some of the very same stakeholders consulted earlier. A key factor was that the details of the PBL, namely the elements of the policy matrix, were not the subject of consultations. When details of the PBL emerged in terms of the specific initiatives and conditionalities, e.g., water user fees, there was clear and significant opposition to the PBL, hence, no implementation to date of key program components.

The relative difficulty of building domestic consensus, and more generally, the politics of policy reform, is linked to the *source* and *scope* of PBL.

#### **b. Source of PBL**

- (i) If key elements of policy reform, e.g., PBL conditionalities, originate primarily from the DMC, chances are that the internal political "game" in terms of the necessary domestic consensus building has either been already resolved, or is in progress. This is likely to be the case since there will be domestic supporters or "champions" of policy reform and PBL, who have an incentive to build such consensus with respect to the PBL.

*Example:* As noted earlier, the Viet Nam Agricultural Sector Program Loan, deemed a success, was implemented in the context of domestically initiated reforms that were well under way prior to the PBL. Similarly, the Financial Sector Program Loan to India, which is deemed to have contributed to the liberalization of the sector, was implemented in an environment of economic liberalization and reform.

- (ii) If the PBL or its key elements (conditionalities) originate externally or are donor-driven, then it may not be clear what form the internal political process and consensus building will take. Therefore the nature of the political game and its likely outcome, e.g., stable agreements on PBL conditionalities, may be much more difficult to predict. The political process of consultation and consensus building may require significantly more time and effort. In the Thai Agricultural Sector Program Loan, difficulties involved popular political opposition and bureaucratic politics; in the Lao Financial Sector Program Loans I and II, questions involved actual commitment of government, and capacity to implement.

### c. Scope of PBL

- (i) If PBL scope is narrow in terms of the number of conditionalities, then the scope for domestic conflict is also likely to be relatively more manageable: there are likely to be fewer conflicting interests involved. Therefore PBL may involve a simpler political game, with more limited players; and it may be easier to build and maintain consensus. This is part of the reason for a preference by DMCs for a “step-by-step” approach to policy reform and PBL, which although leading to more limited and slower reform, is politically generally easier to manage.
- (ii) If PBL scope is very wide, then a relatively greater number of potentially conflicting interests is likely to be involved; especially, since as is likely, each conditionality is in effect, a “political game” in its own right. Therefore, it may be more difficult to reach and maintain the necessary consensus on PBL initiatives. Donors such as ADB are seen as having a preference for wider scope in PBL since this is seen as addressing a greater range of issues and reforms simultaneously.<sup>22</sup>

## E. Institutional Context: From Implementation to Design

### 1. Context: Institutions and PBL Implementation

Institutions are the means by which policy decisions are translated into action. Policy reforms without organizations willing and capable of implementing them are neither credible nor viable. The institutional “infrastructure” of PBL is therefore a fundamental factor shaping implementation and results. These observations would seem self-evident. Yet in general, there is limited recognition of the nature, role, and relevance of the institutional context of PBL. The result is often a lack of realism about the institutional capacity needed to implement and sustain policy reforms and PBL. These constraints often surface at the implementation stage, when institutions do not or cannot undertake required activities and deliver expected outputs—and when compensating for capacity constraints is likely to be relatively more difficult.

*Example:* In the implementation of the Lao Financial Sector Program Loan, it became clear that the capacity of the key institutions involved, the state-controlled banks, was significantly overestimated with respect to both understanding and instituting changes in procedures and operations. The design of the Philippines Grain Sector Program Loan PBL was premised on sufficient institutional capacity on the part of the Ministry of Agriculture to implement the required activities and associated conditionalities. Assumptions about MOA capacity with respect to PBL requirements turned out to be overly optimistic, significantly constraining PBL implementation.

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<sup>22</sup> The discussion here focused on the likely number of stakeholders involved. The intensity of preferences of the stakeholders was not considered, often a key factor in the politics of reform. The assumption here is that other things being equal, the greater the number of potentially conflicting interests involved in policy reform, the more difficult, e.g., time- and resource-intensive, the process of consensus building is likely to be.

The basic institutional “infrastructure” has to be in place as a necessary condition for policy reform and PBL implementation, or there is a high risk that PBL will contain unrealistic or unimplementable conditionalities. It is often not reflected in PBL design that policy reforms vary in their organizational intensity and complexity, and therefore in the nature and extent of the skills and institutional capacity required to implement them. In particular, it is frequently overlooked that most policy reforms and related PBL conditionalities demand administrative, technical, and organizational capacities that are often in short supply in the countries undertaking such reforms. Therefore, policy reform and PBL is fundamentally about institutional capacity building involving considerable time and resources, which must be reflected in PBL design.

*Example:* The generally extensive institutional demands of privatization were noted earlier (Section IIA). Similarly, the seemingly more modest requirements of an effective system for the control of public expenditure and investment, central for stable fiscal policy, can still be challenging. Requirements include, for example, the establishment of multiyear public investment programs, the capacity to monitor projects once launched, and institutional mechanisms that make expenditures transparent and permit a reconciliation of spending and revenue decisions by a diversity of ministries and state-linked enterprises (see Haggard and Kaufman 1992).

## **2. Ensuring the “Institutional Infrastructure” for PBL**

A fundamental requirement in PBL design is an assessment of the institutional context of policy reform, and more specifically the capacity constraints and requirements for implementing PBL initiatives and associated conditionalities. This includes identifying the organizational requirements necessary for implementing particular PBL conditionalities in terms of systems, processes, procedures, structures, incentives, culture, resources, and interorganizational relationships. A comparison of these requirements with existing institutional circumstances can reveal the “capacity gap” as constraint on PBL implementation. Such assessment can lead to more effective PBL by bringing design in line with implementation capacity.

Policy reform and PBL generally involve getting a number of institutions to work together within a common framework. This requires a level of sophistication in coordinating a network of institutions involved in implementing policy reforms and PBL initiatives. Alignment of incentives and the coordination necessary for implementing PBL involving multiple agencies and institutions should not simply be assumed as automatically resulting from the establishment of a “coordinating committee.” In this context, it is essential to assess the relationship among relevant institutions with respect to PBL implementation, including the associated coordination and cooperation requirements. Therefore, PBL design should reflect an appreciation of the real abilities of government to make credible commitments from the perspective of implementation capacity of key institutions.



*Example:* The State Bank of Viet Nam (SBV) signed off on the Viet Nam State Owned Enterprise Reform Program Loan. However, it was the SOEs that actually “implement” the PBL in terms of changes in their structure, processes, operations, culture, incentive frameworks, etc. Their interest and capacity to undertake corporatization seem to have been overestimated, as was the capacity of the central agencies, e.g., SBV, to coordinate implementation. Therefore, the SBV’s signing off with the best of intentions and commitment on the Program did not unilaterally ensure institutional interest and capacity in PBL implementation.

The identification of a possible “capacity gap” in PBL design may be interpreted as a “constraint”, and lead to the modification of policy conditionalities to reflect institutional constraints on implementation. At the limit, it could lead to not proceeding, e.g., postponing PBL. Alternatively, an understanding of the “capacity gap” may be used as an opportunity for including complementary capacity building initiatives, such as technical assistance or TAs, to increase the likelihood of successful PBL implementation. This may involve postponing the PBL until the TAs build sufficient capacity for implementation. It may also involve going ahead with the PBL and TAs in parallel fashion. Although the first option is preferable in terms of preparing the institutional foundations for PBL implementation, the realities of the situation may require the second option. In the case of the Lao Financial Program Loan II, whose implementation has been hampered by institutional capacity constraints, a subsequent parallel TA is seen as having made significant contributions to more effective implementation of the program.

In assessing capacity building requirements, it is important to be realistic about what it takes to build institutional capacity, and its implications for PBL design, e.g., time horizon, resource requirements. Capacity building activities may range from limited improvements in procedures, systems, and processes, or to more substantial efforts at organizational redesign and institutional change. Organizational redesign is generally a complex process, requiring time, resources, and commitment. When it involves basic changes in culture, strategy, and operations as part of a process of transition toward more sophisticated market-based institutions, as in a shift from a public agency or regulated monopoly to a “competitive enterprise”, it may involve a long, complex, and perhaps uncertain process.<sup>23</sup> Therefore, extensive PBL conditionalities that make significant parallel demands on institutional capacity building should be considered carefully in terms of their implications for PBL design, resources, and timing.

### **3. Operational Implications for PBL Design**

Assessment of the institutional “capacity gap” and its implications for PBL design involve asking questions such as:

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<sup>23</sup> Experience with organizational change in advanced country settings like the United States is instructive (see for example Wilkins 1989 or Carr 1996), which puts in context the nature of the challenges facing DMCs.

- (i) Which are the core institutions involved in the implementation of each PBL conditionality?
- (ii) What are the key assumptions about the implementation capacity of each core institution, implicit in each PBL conditionality, i.e., what should the specific capabilities of each institution be for the required PBL activities to be successfully implemented?
- (iii) Are these assumptions realistic in light of an assessment of the existing capabilities of these institutions, or can they do what is assumed they are capable of doing to implement the relevant PBL conditions?
- (iv) What are the key institutional steps involved in implementing the PBL conditionalities, or the decisions/activities of each institution necessary to implement each conditionality?
- (v) How do activities/decisions of individual institutions necessary for implementing each PBL conditionality relate to each other, i.e., what are existing or required linkages, including coordination and cooperation, among institutions to ensure successful implementation?
- (vi) What are the gaps between the existing and required institutional capacity that could constrain implementation of particular conditionalities, i.e., at the level of each individual institution, in terms of coordination and cooperation requirements among institutions?
- (vii) How can these gaps be reduced or the conditionalities changed, and existing institutional capacity strengthened as part of, or complementary to PBL?

The identification of key assumptions about institutional capacity can provide the basis for the identification and assessment of potential institutional “capacity gaps.” Information on the requirements of institutional capacity building may be summarized in an “institutional process map” providing useful inputs to the design of effective PBL and identifying key steps in institutional change and in interinstitutional linkages.

## **F. Mutual Understanding: PBL as a “Joint Product”**

### **1. Context: PBL Design as DMC/ADB Partnership**

As noted in a number of places in this paper, policy reform is essentially a domestic “game” wherein domestic conditions, requirements, constraints, preferences, and behaviors that shape the process and outcomes of reform.<sup>24</sup> Ultimately, it is the responsibility of the DMC government to define the direction, scope, and strategy of reform; and to manage the implementation process so that it yields the desired results. External donors such as ADB play a supporting role by providing resources and advice. In this context, PBL as an element of policy reform is essentially

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<sup>24</sup> This is consistent with the general assessment of PBL by other IFIs. See in particular Dollar and Svensson (1998).

a partnership between the donor (ADB) and the government. However, the DMC/ADB partnership is shaped and tested at various stages in the PBL process.

The initiation of the PBL and the negotiation for any new phase are key moments in building and reaffirming DMC/ADB partnership. The initiation of the PBL offers an opportunity to discuss the nature of the PBL that may set the stage for the nature of the relationship over the life of the PBL. This involves both the choice of conceptual framework and the definition of the scope and key elements of the PBL.

*Example:* In the earlier examples of the Indian Financial Sector Program Loan and the Viet Nam Agricultural Sector Program Loan, there was a general convergence of views between ADB and the respective governments on the broad nature and role of the PBL. In the case of the Viet Nam State-Owned Enterprise Program there was partial convergence of views after significant discussion and negotiation (over the concept of “corporatization”). In the case of the Lao Financial Sector Program Loans (I and II), there is a perception of limited convergence of views (on the Leasing Decree, Bankruptcy Decree, publishing of audit results of state-run banks).

In general, as noted earlier, there is a tendency for government to define the scope of PBL in a more limited way, and prefer an incremental strategy of change. Donors, on the other hand, often prefer a wider scope and more comprehensive approach to policy reform and the role of PBL. Therefore it is essential to make explicit the relevant perspectives on policy reform and PBL as early as possible in the process of design, as the basis for discussion, debate, and hopefully for building agreement.

Equally important in shaping the quality of the DMC/ADB relationship is the implementation process, in which the issues of conditionality and associated donor pressures play a central role in attempting to move reform from intent to action. The “watchdog” in this process is the policy matrix: For the donors, PBL implementation is defined in terms of compliance with conditionalities, which are assumed to be “certainties” in terms of their relevance and feasibility to policy reform. For government, PBL initiation and implementation are generally “reality tests” with respect to the assumptions and expectations embodied in the PBL conditionalities.

A key factor in establishing and maintaining DMC/ADB partnership is a shared concept of the overall nature of policy reform and PBL. Reform is more than simply a set of discreet decisions and activities embodied in a PBL document. It is fundamentally a process of change—technical, political, institutional, and perhaps even ideological,<sup>25</sup> which shapes actual PBL activities and outcomes. The establishment and maintenance of mutual understanding, including shared expectations between government and ADB is therefore a continuing requirement for an effective partnership, to be verified, reconfirmed, and maintained throughout the PBL process.

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<sup>25</sup> As in the case of economies in transition.

## 2. Building Mutual Understanding and Shared Expectations

Government decision makers need to understand and have a level of comfort within their own frame of reference and language with the role, scope, strategy, activities, and expected outcomes of the PBL, including the meaning and implications of conditionalities. Such understanding is a critical precondition for government “ownership” of PBL, and therefore for the necessary commitment.

In practice, there may be key differences in understanding between the government and ADB, including with respect to what each sees as “relevant” and “feasible” in policy reform and therefore PBL conditionalities. Constraints on mutual understanding may stem from a number of different sources, with differing operational implications for resolving such differences:

- (i) *Differences in available data:* sequence and number of steps involved in approval of a decree or passing of legislation; number of SOEs considered “large”, and therefore a candidate for corporatization and inclusion in the PBL

May be resolved by verifying and using a common data base in PBL design: identify explicitly details of the process for approval of a decree or passing legislation; examine jointly available SOE data.

- (ii) *Differences in interpretation of data arising from different “models” of reality (analytic frameworks), and /or differences in the meaning of concepts:* time expected for approval of decree or legislation ; meaning of “large SOE” and “corporatization”

May be resolved by clarifying the operational implications of key concepts, for example, by making explicit the underlying assumptions and their implications: assumptions about potential constraints in the approval of decree or legislation; rationale for the particular definition of what constitutes a “large” SOE; assumptions about operational implications of corporatization.

- (iii) *Differences in values and preferences, or what is deemed as important:* preference for including/not including bankruptcy legislation in the PBL; preference for focusing on large SOEs instead of smaller SOEs, and on “equitization”

Generally cannot be resolved through more data or analysis, nor by clarifying rationale and assumptions; involves discussion and debate, and requires a shift in perspective or preferences or mutual accommodation: discussion/debate can be assisted by explicit key assumptions and their implications.

*Example:* In the Lao Financial Program Loan II there was a basic difference on the issue of “bankruptcy legislation.” The Lao Government interpreted the conditionality to mean formulating the decree; ADB’s position was that the decree had to be approved for compliance. Similarly, in the Lao Financial Program Loan there was a fundamental difference in the interpretation of what is meant by the conditionality to “publish audit data” on state controlled banks. In both cases it took significant effort and time to bridge the gap in interpretation.

*Example:* In the Viet Nam SOE Program Loan the initial emphasis by ADB was on SOE privatization, or “equitization” as the basis of PBL. The government understood the concept but felt it was not appropriate to the country context at the time as the basis for PBL. Eventually the concept of “corporatization” evolved as a basis for agreement, although it is not yet clear whether there is a complete congruence on the meaning and operational implications of this core program concept among all the key stakeholders involved.

*Example:* The Viet Nam Agricultural Program Loan, although deemed supportive of the reform process, is an example of the different types of potential misunderstandings. Although there was a general congruence of views on policy reform, there was a basic difference about the “feasible timing” of reforms. These arose from differences about what activities were seen as operationally feasible in the given context of PBL, with ADB pushing a “fast track”, and the government a “step by step” approach. There were basic differences in understanding of key issues involved in the PBL, namely, trade policy, private sector role, liberalization. There were basic differences in what should be the appropriate scope for the PBL, with ADB pushing a wide scope (for the conditions in the policy matrix), and the government for a more focused and limited approach (in terms of the conditions). Most fundamentally, there were basic differences in judgments of value in terms of the removal of quotas on rice and fertilizer, seen as issues of efficiency by ADB, but as fundamental concerns of food security by the government.

The language of PBL discussion and negotiations, generally English, can become an important unrealized constraint on mutual understanding. This can occur because of the differences in the English language capabilities of ADB and government officials. As a consequence, problems could arise for example, because of lack of understanding or basic differences relating to the meaning of key concepts. However, misunderstandings can also result from a reticence on the part of the DMC participants to discuss fully their views and preferences in meetings in a foreign language where they do not have a sufficient level of comfort. As a consequence, there may be a feeling on the part of donors that a clear mutual understanding has been reached and to proceed on that basis, whereas the DMC representatives have significant reservations that do not emerge until much later in the PBL process (during policy making or implementation) when managing such differences is more problematic.

One source of constraints on mutual understanding may arise from the nature of the PBL instrument and process, which may not be fully understood by DMC officials used to working with ADB on the basis of investment project loans. In virtually all the DMC country interviews (Kazakhstan, Lao PDR, Nepal, Thailand, Uzbekistan, Viet Nam) there was a general stress on limited experience and therefore lack of familiarity with PBL instruments, in particular, program loans and sector program loans.

In terms of building mutual understanding, discussion of general principles and concepts is not the same as joint design. In order to ensure mutual understanding, the details of the PBL, in particular the operational meaning and implications of specific conditionalities as understood

by each party, must be stated and discussed. Otherwise there may be an impression of mutual understanding and agreement where none exists; with significant misunderstandings arising later in the process, with either side or both feeling that the consultations were not in “good faith.”

*Example:* This was reflected in earlier examples of differences in the Lao FPLII with respect to the bankruptcy decree and the posting of the audit results of the state controlled banks. Similarly, it was reflected in the differences with respect to the Thai Agricultural Program Loan with both the Ministry of Agriculture and key stakeholders, following what were thought to be successful discussions.

Given the central role of international consultants in ADB’s PBL activities, they have a potentially significant impact on building—or constraining—mutual understanding between ADB and the government. They can act as de facto “gatekeepers” in the dialogue between government and ADB, influencing how issues are framed and interpreted. International consultants can facilitate or hinder mutual understanding and agreement between government and ADB, especially in their role in defining the policy matrix. For example, if international consultants have insufficient understanding of the DMC policy reform process and context, they may be the source of conditionalities that are not seen as relevant or feasible by the government. At the same time, given the short-term nature of most ADB consulting relationships, international consultants may not have sufficient appreciation of ADB’s culture, strategy and operational approach with respect to PBL and to the more general ADB/DMC relationship of which the particular PBL is one aspect. This can also constrain PBL design, and impact on the broader relationship between the DMC and ADB.

Consultants can also contribute to building agreement, as a conduit between ADB and the government in PBL design, by raising sensitive issues that may be difficult for the government and ADB to raise with each other. Similarly, international consultants can introduce ideas on policy reform domestically that the government may not wish to raise as their own, i.e., as “trial balloons” for the government and/or ADB.

Constraints on mutual understanding can be especially prevalent when policy reforms are based on “international best practice blueprints”, particularly in the context of donor-driven reforms and PBL where a donor such as ADB may feel that it has a clear and correct, or at the very least, sufficient understanding of DMC needs. Whereas the focus of the government, as noted, is likely to be on ensuring both relevance and feasibility of reforms to the particular country context. Under these conditions there may be basic differences in perceptions and preferences between ADB and the government (“equitization” in Viet Nam; bankruptcy decree in Lao PDR). The two sides may be using the same language but with quite different meaning, and talking “past each other” (“publishing audit results of State Controlled Banks” in Lao PDR; “corporatization” in Viet Nam—both of which took a long time to reach shared understanding and agreement).

### 3. Operational Implications for PBL Design

It is important to undertake PBL with the perspective that mutual understanding on policy reform is a necessary condition for effective PBL, but that it cannot be assumed to exist: it needs to be built, verified, and maintained over the life of the PBL. This requires the identification and joint discussion of questions raised earlier that relate to various factors conditioning policy reform and PBL. As noted, mutual understanding is required on these issues at the design stage; but these questions need to be monitored, or at the very least revisited as the PBL process evolves:

- (i) *Why the PBL:* What is the nature and specific characteristics of the policy issues that define the need for reform and for the particular PBL (Section IIB)
- (ii) *What is the PBL's specific contribution to reform:* what is the role of key PBL components in the reform process, or the contribution of the expected outcomes of specific conditionalities to the desired results of reform (Section IIB)
- (iii) *What are the critical success factors in PBL initiation, implementation, and sustainability, including, with respect to each conditionality:* key steps and potential constraints in the policy making process, including approval and initiation (Section IIC); key institutional requirements for, and constraints on implementation (Section IIC)

Where differences in perspective or position are identified with respect to the nature of the policy issues that are the basis of reform and PBL, it is important to try to establish the basis for the differences in order to manage them most effectively. For example, in terms of the concepts introduced earlier, do they arise from: (i) differences in data; (ii) differences in interpretation of data or meaning of key concepts; or (iii) differences in preferences and values. Understanding the nature of the differences can assist in selecting the most effective means for resolving or at least managing them in the context of PBL design.

## III. CONCLUSIONS

The development challenges of the Asian and Pacific region have evolved over the past three decades. ADB's role and operations have also changed in response to these emerging challenges.<sup>26</sup> A critical constraint on development at ADB's inception, and a focus of ADB's initial role and operations, was the lack of physical and social infrastructure—challenges whose relevance continues today. In responding to these needs, ADB was primarily a project lender, supporting physical and social investment in development. As experience with development accumulated, it became increasingly clear that while investments are necessary for development, they are far from sufficient. The policy and institutional environment plays a critical role in shaping

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<sup>26</sup> See, for example, Appendix 1 and 2 in ADB (2001).

development. As a consequence, ADB's role has evolved, with policy and institutional reforms playing an increasingly important part in ADB's operations. Consistent with these changes in focus, ADB complemented its project lending with modalities focusing on PBL (program lending in the mid-1980s; sector development programs in the mid-1990s).

Given the nature of the challenges in the region, PBL is likely to play an increasingly important role in supporting development through policy and institutional reforms. However, in this context, experience with PBL has been rather mixed to date. Between 1987 and 1999, ADB made 65 program loans and 13 sector development program loans (see OEO 2000). In spite of the effort and resources, a recent evaluation concluded that program loans and sector development program loans have made limited contribution to DMC policy reform to date (see, for example, OEO 2000).<sup>27</sup> Constraints on their effectiveness, although in part due to the nature of the program loan instrument, arise to a large extent because PBL deals with complex and sensitive issues. It is very difficult for governments to implement sustainable policy reform: it is a "high risk", if potentially "high impact" undertaking. Therefore, it is not surprising that ADB would find PBL complicated and problematic. However, given the requirements of development in the region, *the challenge to ADB is not to do less PBL; but to do it better.*

It is the suggestion of this paper that PBL require a fundamental change in perspective: a shift toward a political economy approach to PBL. This, in turn, has certain general implications for ADB in approaching PBL. These include the following:

- (i) *Preparation for PBL:* Given the complexity of the policy reform process and PBL initiatives, and associated risks for both donors such as ADB and DMC governments, it is essential to ensure a thorough understanding of the country and policy context, including an emphasis on political economy factors identified in this paper. This requires an organizational recognition of and commitment to the need for sufficient preparation, and the associated time, resources, and skills needed for the planning and implementation of successful PBL initiatives.
- (ii) *Tolerance for uncertainty:* Given the uncertainty arising from the complexity of policy reform, including its fundamentally political nature, PBL initiatives cannot be designed up front with any certainty, however extensive the preparations. Policy reform is more in the nature of an unfolding experiment than the implementation of a fixed blueprint. Therefore conditionalities in PBL are best seen as "working hypotheses." This requires a level of flexibility in PBL instruments, supported by an organizational emphasis on and capacity to monitor PBL, a readiness to learn during implementation, and to make adjustments as needed.
- (iii) *Emphasis on sustainability:* Given that the fundamental role of PBL is to support change that leads to tangible improvements specifically policy and institutional reform, it should not seek to introduce policies and initiatives that may not be

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<sup>27</sup> This is not unique to ADB, as the World Bank experience also reflects the same (see Dollar and Svensson 1998; and Collier 2000, 1999).



sustainable over a reasonable time horizon, no matter how attractive (“optimal”) in principle. This may mean the readiness to adopt or support “second” or even “third best” policies, perhaps as part of a process of incremental change, if they are more likely to lead to actual improvement.

- (iv) *Recognizing PBL as a process of DMC capacity building:* Policy reform and PBL is about implementation: getting changes in place to yield desired improvements. In this context, beyond addressing particular policy issues, PBL involves improving institutional capacity for policy making and implementation. Such capacity building for implementation, therefore, has to be a central focus of support in PBL from the outset.
- (v) *Knowledge base:* Effective PBL design can benefit from a continuing analysis of cross-country experience, including both lessons of success, and lessons from failure. An emphasis on the development of an evolving “knowledge base” on regional experience and issues related to policy reform and PBL would provide strong support for effective PBL that is appropriate to the diverse characteristics of Asia. It would support the transition toward a genuine “learning organization.”

As noted at the beginning, understanding the implications of the political economy factors in policy reform are unlikely to eliminate the difficulties associated with PBL, given the nature of policy issues and the reform process. However, with a better understanding and explicit consideration of such factors, perhaps the frequency and intensity of the problems associated with PBL may be substantially reduced. The result is likely to be more relevant and feasible PBL initiatives, strengthening their likely contribution to the development process.

## Annex 1

### Conceptual Note on Complexity: “Ill-structured” Nature of Policy Issues<sup>1</sup>

The PBL design, in general, and the policy matrix in particular, is in effect an implicit “model” in a broad sense, of the policy context. It embodies and structures information deemed relevant, and key assumptions about the policy issue, associated reforms, and expected outcomes. In particular, it reflects existing information and assumptions with respect to:

- (i) Core characteristics of the policy issue, e.g., key elements and relationships among these elements assumed to require attention and resources in policy reform, as well as associated interests;
- (ii) Desired results, e.g., assumptions about what constitutes “improvement”, including implicit resolution of any differences in stakeholder preferences;
- (iii) Means/ends relationships, e.g., core PBL activities embodied in conditionalities that link the policy issue, its resolution, and desired results, reflecting how implementing conditionalities will lead to the desired improvements.

In this context, how the policy issue is posed or structured plays a significant role in shaping the approach that will be taken in attempting to respond to it, i.e., the reform strategy and program. This “model” of the policy issue, however informal or implicit, will direct attention to certain characteristics or element of the policy environment, and frame the issue in particular ways. The examples in the main text of the Viet Nam SOE Program, and the Lao PDR FSPLI/II are illustrations. Therefore the appropriateness of the “PBL model” to the actual policy issue and country circumstances will shape the likely relevance and feasibility of suggested policy reforms and associated conditionalities.

Conceptually, there has been a tendency to approach PBL as a problem in “optimal policy design.” The focus is on desired and “known” outcomes as the results of reform and PBL conditionalities. The fundamental if implicit assumption is that the policy issue and the reform process are “relatively well structured” and understood, requiring primarily the design and application of an “optimal reform program.” The implicit characteristics of the policy reform context, if somewhat idealized, include:

- (i) single—if composite—decision maker such as “the government”;
- (ii) relatively well-defined and known goals and preferences, e.g., goals and objectives of reform;
- (iii) a policy issue whose elements and their relationships are generally known;
- (iv) a resolution that involves a limited and known set of alternatives;
- (v) means/ends relationships that are reflected in these alternatives—i.e., between the policy issue and its required resolution, including key factors as “conditionalities”;
- (vi) relatively certain outcomes and impact; and

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<sup>1</sup> Based on Abonyi (2002); see also Abonyi et. al (1989).

- (vii) considerations of the desired results of PBL, e.g., supported by “with/without” analysis, which are sufficient to guide its role and design.

In examining experience with PBL, a different picture emerges of the actual policy context. It is one of policy issues being more “ill-structured”, whose key characteristics include the following:

- (i) many “decision makers” involving multiple stakeholders, none of which has complete power to determine outcomes namely policies, their implementation, and associated outcomes, e.g., “government is not a unitary or sole ‘stakeholder’
- (ii) multiple, ambiguous, and conflicting goals and preferences
- (iii) a policy issue whose elements and their relationships are generally not fully known or understood, and where different stakeholders may have different perspectives of the issue and its implications for reform
- (iv) a resolution that involves a potentially wide range of alternatives whose characteristics may not be known at the outset
- (v) means/ends relationships reflected in these alternatives are highly uncertain— i.e., between the policy issue, required reform program, and actual outcomes
- (vi) outcomes and impact are highly uncertain and may not be fully known at the outset
- (vii) addressing the policy issue is an evolving and uncertain process of change that should be reflected in the role and design of PBL

Annex Table 1. **Nature of Policy Issues**

Dimensions	Structure of Policy Issues	
	Well-Structured	Ill-Structured
Decision Maker	one/few (composite)	many
Desired Ends	well-defined/consensus	ambiguous/in conflict
Elements of policy issue	manageable set /known	many/not fully known
Reform Alternatives	relatively few/known	many/not fully known
Means/ends relationships, e.g., role of conditionalities in policy reform	relatively well understood	highly uncertain
Outcomes	relatively certain; associated risks within reasonable known bounds	highly uncertain; not all sources of risk known
Implications for PBL design	focus on desired results	focus on both desired results and change process

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“Ill-structured” policy issues involve three general characteristics with important implications for PBL design:

- (i) *Complexity*: Policy issues have many elements and interconnections (“feedback loops”) among these elements through which change (e.g., small disturbances in different parts of the policy environment) may multiply/amplify, or cancel themselves out. There are various leverage points—many of which may not be obvious—where policy intervention may focus in order to bring about desired change. Furthermore, there are generally strong interconnections (“feedbacks”) among different policy issues. There are therefore many possible ways of representing the issue (alternative “models”), and corresponding approaches and programs of action to address and resolve the policy issue.<sup>2</sup>
- (ii) *Conflict*: Policy issues are characterized by the existence of multiple stakeholders with differing and inconsistent perceptions; with competing and conflicting interests, preferences and expectations; who have the power (singly or in coalitions) to influence outcomes. There is generally no one stakeholder who has full control of the policy environment. Nor is there likely to be a single incentive framework that can reconcile differing interests. Therefore policy issues and their resolution do not involve “optimization” by a unitary decision maker with a well-defined set of objectives. Instead, it involves mutual accommodation by a set of stakeholders with an interest in the issue and its resolution, who must reach—and maintain—a “stable compromise” on a program of action.<sup>3</sup>
- (iii) *Uncertainty*:<sup>4</sup> Policy issues are characterized by different types of uncertainty. There is uncertainty arising from the complexity of the policy context, relating to the appropriate representation of the policy issue, e.g., what are the key elements and relationships that should be the focus of attention and the basis for specific policy reforms and programs of action. Uncertainty is associated with means/ends relations, i.e., about the likely consequences and therefore likely effectiveness of policies and programs of action, and associated PBL conditionalities. The likely resolution of conflicts associated with the policy issue and the nature of their resolutions are also uncertain, i.e., what kind of stable compromises are likely to emerge with respect to the formulation of the policy issue and mutually acceptable programs of action. Finally, since resolving the policy issue (implementing PBL) involves a process of change, there is uncertainty how the change process will unfold and its likely outcomes.

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<sup>2</sup> See for example the pioneering work of Forrester (1971).

<sup>3</sup> See Radford (1977), based on Howard (1971).

<sup>4</sup> The term “uncertainty” is consistent here with the normal usage of that term as denoting lack of certainty, vagueness, ambiguity.

Analysis of experience suggests that policy issues and reform are perhaps better approached as “ill-structured” from the outset. That is, it may be more realistic and effective to recognize and accommodate in PBL design, to the extent possible, complexity, conflict, and uncertainty as characteristics of the policy context.

## Annex 2

### A Perspective on Conditionalities

The purpose of conditionality is to help bring about effective and sustainable policy reform with respect to particular policy issues, in order to contribute to improved country performance and quality of life. Conditionalities link or “intermediate” the policy issue and desired results by specifying key actions to be taken that are expected to lead to improvements. In this, conditionality relates to both the design of PBL and its implementation; and the two are closely linked. There is little value in designing unimplementable PBL; and there is similarly little value in implementing poorly designed PBL that are not likely to contribute to bringing about the desired policy reform and their desired outcomes.<sup>1</sup> In this context, policy conditionalities in PBL reflect significant prior assumed knowledge about the policy reform process and its expected outcomes; and the related role of PBL and associated conditionalities. In particular, policy conditionalities implicitly assume that:

- (i) The nature of the particular policy issue is known, i.e., key elements and associated relationships that have given rise to the problems requiring reform;
- (ii) Nature of the needed policy reforms are known, i.e., key “policy levers” and how they should be manipulated to bring about improvements;
- (iii) There is sufficient consensus on what defines success in policy reform, i.e., what constitutes “improvement”;
- (iv) Policy reform embodied in the conditionalities will be implemented as planned and sustained over the relevant time horizon, i.e., the capacity to implement the policy conditionalities exist;
- (v) Implementation of the conditionalities will lead to desired results, i.e., if the policy conditionalities are met, they will contribute significantly to policy reform and improved performance.

From this perspective, policy reform and associated PBL conditionalities assume a great deal of knowledge about the policy issues and their context, and are effective means for bringing about improvements, societal consensus, and implementation conditions and requirements. Given the complex nature of policy issues, there are generally limits on knowledge and significant uncertainty about means/ends relationships related to policy reform.<sup>2</sup> Such reform is by its nature a “process of change”, meaning a sequence of activities—some technical, some political, some institutional—that condition over time the shape of the policy, its implementation, and its impact.

Review of experience indicates that introducing policy reforms and associated conditionalities without sufficient preparation can increase the likelihood of failure either in implementation, i.e., actions not taken as planned, or in terms of actual outcomes. Furthermore,

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<sup>1</sup> See for example Bird (1999); also Copenhagen on the “perestroika of conditionality” (Wood and Lockwood 1999).

<sup>2</sup> See Section II in main text, and Annexes 2 and 3.

there is indication that in the political context of policy reform, once proposed policies and reforms are seen to fail, it may become more difficult to introduce them a second time. Therefore if PBL conditionalities force the introduction of policy reforms without adequate readiness or preparation, they may actually retard policy reform over the longer term.

As conditionalities increase in number and detail, so does their assumed knowledge about the policy context, process of reform, and political consensus necessary for implementation, and therefore the likelihood inappropriate assumptions and failure in bringing about desired reforms and outcomes. Similarly, as conditionalities increase in number and detail, so does the scope for differences among stakeholders (government and ADB). As noted, governments, for example, generally place greater emphasis on the politics and feasibility of reforms and associated distributional impacts, since these affect their ability to implement present and future reforms, and retain power. Furthermore, governments are often concerned about loss of control over the domestic policy agenda; and over the pace and sequencing of the reform process.

Given the above, there may exist a “conditionality Laffer curve” (Bird 1999). The higher the cost of assistance in terms of numbers and details of conditionalities, and the greater the discrepancy in perceptions and preferences between the government and ADB, the lower the likelihood of implementation of the conditionalities by government. In this context, it may be more effective for PBL design and associated conditionalities to be more limited in number; more modest in scope; and more ready to adapt to changing conditions.<sup>3</sup>

In general, it is essential not to lose sight of the basic intent of PBL in the details and conditionalities of the policy matrix. The basic intent of policy reform and therefore of PBL is sustained change: reform or adjustment in key policy areas in order to bring about perceived improvements in performance and quality of life. The purpose of PBL is not to ensure compliance with a large set of conditionalities “because they are there.” From this perspective, of conditionalities as inducing sustained reform in practice, the following could provide guidelines:

- (i) Select conditionalities carefully so that they reflect the key dimensions of the policy issue and clear requirements for associated reforms, i.e., clear logical relationship between the conditionalities, policy issue, required reforms, and desired outcomes.
- (ii) Keep conditionalities to the minimum necessary to address key aspects of the policy issue, and ensure that each conditionality is relevant to the issue, associated reforms, and desired outcomes.

*Test question:* What specific difference would it make to the desired results of policy reform if this particular conditionality were left out of the policy matrix? Does it matter or is the difference significant in terms of the purpose of the reform?

- (iii) To the extent possible, ensure that each conditionality is feasible or implementable in the actual country context, including institutional capacity.
- (iv) Keep in mind the basic reason for PBL in supporting policy reform, and be ready to adapt to new information and changing conditions.

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<sup>3</sup> This is also a function of the nature of the PBL instruments in accommodating such change.

## Annex 3

### A Perspective on Government Commitment

It has been noted that government “commitment” often seems to decrease after the initiation of PBL, showing up as problems of “second tranche compliance.” This may indeed arise from lack of intent or interest in implementing reforms, the usual interpretation of “lack of commitment.” However, it may be that it is less a question of flagging government interest, and more of other factors such as a lack of clear understanding (or similar understanding as ADB) of conditionalities in terms of their operational implications. It may also be that conditionalities turn out in practice to be unrealistic in terms of what the government is actually able to. In general, Government commitment is perhaps best seen as involving three dimensions;

- (i) *Understanding*: Commitment relates to the level of government understanding of policy reform and PBL requirements, and in particular, to a mutual understanding and shared expectations between government and ADB with respect to the policy matrix or conditionalities.
- (ii) *Intent*: It also involves having the intent, interest, and incentive to implement the required policy reform and associated PBL conditionalities.
- (iii) *Capability*: Commitment also relates to both the political and institutional context of reform. This includes sustained commitment requiring sufficient *political support* to initiate, implement, and sustain reforms; and *institutional capacity* to implement the agreed policy reforms.

Perceived lack of commitment by government may therefore arise from a variety of sources. It may mean that government has a different understanding from ADB of the meaning or implications of particular conditionalities. It may involve a lack of sufficient intent to implement conditionalities—the usual meaning of “lack of commitment”—perhaps because they are seen as either not relevant or not feasible, but were agreed to in order to secure funds.<sup>1</sup> Or alternatively, government may have had both an understanding of the conditionalities and a genuine intent to implement them, only to find as the reform process unfolds that it did not have the capability to do so either because of political resistance, or because of constraints on institutional capacity. Each type of constraint on government commitment is likely to require a different approach.

There are likely to be significant differences among countries in terms of level of “commitment” in one or more of the above dimensions, e.g., the policy reform context and capabilities of Nepal, Viet Nam, and India differs significantly. There may also be key differences

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<sup>1</sup> In practice, a government may agree to policy conditionalities quickly—but seemingly not move effectively to implement them because of political and/or institutional constraints. Alternatively, a government may take a long time in negotiations, but once agreement is reached, move decisively to implement. Furthermore, what seems like “firm government commitment” at the time of PBL agreement may turn into a lack of commitment as implementation evolves.



in terms of government commitment within the same country over time, or among different policy issues, such as financial sector vs. agricultural sector reforms.

It is therefore useful to understand in PBL design the actual as distinct from nominal government commitment to undertaking policy reform, and how this may change over time. This involves an assessment of the understanding, intent, and capacity of government in the context of the particular policy reforms involved and associated PBL conditionalities, and monitoring government commitment “in three dimensions” as implementation evolves.

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