

TOWARD A POLITICAL ECONOMY APPROACH TO POLICY-BASED LENDING

GEORGE ABONYI
INSTITUTE OF SOUTHEAST ASIAN STUDIES

ABSTRACT: *This article suggests that basic and recurring problems associated with policy-based lending (PBL) of international financial institutions (IFI) such as the Asian Development Bank (ADB) and World Bank go beyond problems of implementation. They arise because of characteristics of the policy environment: the political economy context within which design and implementation of PBL takes place. As a consequence, political economy considerations should be explicitly recognized from the outset, accommodated in PBL design, and monitored as implementation unfolds. This may reduce the gap between expected and actual results in policy reform and PBL, and increase the development effectiveness of IFIs. While 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 be reduced if the political economy context is reflected from the outset in the PBL design process.*

The purpose of this article is to explore key political economy¹ factors shaping policy reform in the context of policy-based lending (PBL).² A better appreciation of these factors and related concepts can help strengthen the joint capacity of developing countries and international financial institutions (IFIs) to design more effective PBL initiatives supporting policy reforms.

The starting point is the proposition that for PBL design to be effective, it should be both 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).

Direct all correspondence to: George Abonyi, 295 Clemow Avenue, Ottawa K1S 2B7, Canada.
Email: abonyi@loxinfo.co.th

The approach presented in this article, focusing on political economy factors, is intended to help bring about more relevant and feasible PBL. It may be summarized briefly as follows. 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 that involve a particular distribution of benefits and power 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. This process of change is likely to involve a time horizon that extends far beyond the time frame of a particular PBL.

Policy reform and PBL as strategy of change involve tensions between two basic and potentially competing approaches. 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. IFIs often approach PBL design based on principles of international best practice built on experience with many countries in various situations, i.e., with 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. Governments tend to focus on unique country characteristics and constraints as the basis for reform and PBL strategy, e.g., with emphasis on doing things right in terms of country relevance and feasibility. From this perspective, policy reform—and PBL design—involves devising new rules for specific contexts. The challenge in PBL is to build on the two approaches in order to bring about desired changes.

The process of change involved with PBL and its outcomes, is shaped by four key factors: the complexity of the policy issues, the process of policymaking, stakeholders or political players in policy reform, and institutions involved in policy formulation and 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. In this context, the policy process refers to 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. An understanding of policy processes associated with particular PBL activities is essential to the design of effective PBL.

Policy reform is to a large extent political in nature. Therefore, understanding the role of 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 insure their successful implementation. Policy reforms and associated PBL activities 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.

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—in particular, governments that must manage the process of domestic policy reform to which the PBL is intended to contribute and the IFIs that provide 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 associated conditionalities.

POLICY REFORM AS CHANGE: A PROCESS PERSPECTIVE ON PBL

Policymakers are generally aware of the difficulties brought about by changes inherent in policy reform; ultimately 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, for example through a representation of the ‘with reform/PBL’ situation as compared with the situation ‘without reform/PBL’ (see Evans 1999). 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 an effective framework or sufficient guidance for designing a PBL with an increased likelihood of success.

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 policymaking usually modifies to varying degrees—and 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. Experience with policy reforms indicates that they may threaten a wide range of interests associated with the existing system. 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, may be blocked, or may be modified to varying degrees such that the final outcome is very different from that intended by policymakers (see, for example, Grindle and Thomas 1991; Haggard and Kaufman 1992).

Examples: In ADB's Philippine power sector restructuring program loan, the rationale for reform and associated benefits was 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 policymaking (i.e., legislative) process, as was the associated program loan. In the case of ADB's agricultural sector program loan to Thailand, 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 ADB's second Lao financial sector program loan, a required leasing decree was eventually passed (after failing to pass under the first such loan), although there is significant uncertainty about institutional capacity to implement this decree.

Example: In the case of Thailand's agricultural program loan, proposed reforms (e.g., 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 the case of Thailand's social program loan, the proposed decentralization of state-run schools was blocked at the implementation stage by opposing teachers. In the case of Sri Lanka's agricultural sector program loan that involved removal of fertilizer subsidies, a government was subsequently elected 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 (SOE) 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 insuring the existence of a sufficiently competitive or appropriate regulatory environment to insure 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 consequences can be known at the outset with certainty.

Example: The Vietnam agricultural sector program loan was deemed a success. However, this loan was implemented in the context of domestically initiated reforms that were well underway 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 1999a). In the case of the Lao financial sector, 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.³ It is, therefore, not unusual to find an increasing gap between announced intentions of government and the actual policy choices and outcomes. The role of government commitment in PBL should be seen in this context (see annex 3 in Abonyi 2002 for a discussion of government commitment). To be effective, it is essential to insure, 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 policymaking 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.

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 will be required for initiating and implementing PBL, the more resources will 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:

- (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., steps, institutions, and participants involved in approving and/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 differences among stakeholder preferences;
- (v) institutional requirements, i.e., extent of required changes in processes, systems, procedures, incentives, and cultures, and number of agencies/institutions involved; and,
- (vi) mutual understanding between IFI (e.g., ADB) and government, i.e., the gap between the IFIs and the government on the nature, role, scope, design, and expected outcomes of PBL.

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

Change Strategies: Global Blueprints and Local Incrementalism

There are two general (if here somewhat idealized) approaches to policy reform as 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 be shaped by new rules. 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.

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 formal, 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 should drive 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 country 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 rather than a strategy that places greater emphasis on the feasibility of change given initial conditions (see annex 2 on institutional change in Abonyi 2002).

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 insuring that policy reform leads to actual improvements in country performance or quality of life, and 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 reform 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.

A Delicate Balance

There is a perception that IFIs often attribute unrealistic capabilities to governments in the policy reform process.⁴ As a consequence, IFIs are seen 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 the political stability necessary, and that the institutional capability 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 in practice with the IFI's key central agency counterpart, e.g., the Ministry of Finance (MOF).

Example: Vietnam is a multilevel society in transition, made up of many stakeholders with respect to policy reform, e.g., ministries, state-owned enterprises (SOE), the Communist 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 Vietnam 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 the 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, beyond the boundaries of the PBL. 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 as measured against particular country context. Where such best practice guidelines do not fit, appropriate policy initiatives may be devised based on the characteristics of the specific policy issues and particular country context, but perhaps reflecting applicable general principles, e.g., the role of markets. An important role of an IFI such as the Asian Development Bank or the World Bank is to insure 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 article.

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 down the foundations for the sustainability of reforms once the immediate pressures of the crisis subside.

Fundamentally, government and key stakeholders need to buy into basic policy reforms: a certain level of societal readiness is necessary for policy reform and PBL. Unless there is sufficiently broad-based support, policy reform is not likely to be implementable or sustainable. Therefore, a key challenge is to insure 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 insure that the associated reforms are likely to stick beyond the crisis. The difficulties involved often show up as problems in the implementation of the PBL (e.g., difficulties with second tranche conditions) when the crisis recedes and the urgency of the reforms or of the pressures of the financial constraints are less, and therefore the commitment to change decreases.

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 (for a more extensive development of the nature of complexity of policy issues and its implications see annex 1 in Abonyi 2002). 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 (feedback) among these elements, through which change (e.g., 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: Reforms and associated PBL conditionalities for the privatization or corporatization of SOEs relate to factors such as legal, financial, and accounting frameworks; administrative procedures; technical and managerial skills; changes in organizational culture; and 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. This relates to the very foundations of PBL design: what specific aspects of the policy issue should be the primary focus of attention to support desired reforms, what PBL initiatives are likely to be most effective, and how these initiatives will lead to desired results. 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: it may involve errors of omission, i.e., leaving out key aspects of the policy issue whose relevance 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 ADB's first Lao financial sector program loan and eventually passed under the second program loan after a long and difficult process. The relevance of a complicated decree to improving the performance of the financial sector and more generally on country economic performance is not clear, 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 ADB's Vietnam state-owned enterprise 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 an 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 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 emerge, or as desired results do not materialize even when conditionalities are complied with. The second type of problem often reflects clearly the mismatch between PBL design and the structure of policy issues, since it involves conditionalities being met, yet does not lead to appreciable reform.

Complexity and Conditionalities

Conditionalities link or intermediate the policy issue and PBL design, defining the operational focus of PBL. They simplify the complexity of the policy issue by specifying selected key actions to be taken that are expected to contribute significantly to reform. The policy matrix of a PBL (often consisting of extensive and detailed conditionalities, done under considerable time pressures) 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 expected 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 not to include too many conditionalities, excessive details, and inflexibility. An overdesign 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 is expected to generate, has generally not proven to be the most effective means for PBL to support implementable and sustainable reform (for further discussion of this perspective on conditionalities see annex 2 in Abonyi 2002).

Example: ADB's Philippine capital market development program loan, terminated after the first tranche, had forty-four policy reform activities, including the requirement for a securities regulation code that had eighteen sections. The Thai agricultural program loan has thirty-two conditionalities, including three requiring legislation.

From a methodological perspective, the program framework matrix (or its equivalent) 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 elements of 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 (e.g., a government commitment to

allocate more resources toward reducing school dropouts), process milestones (e.g., establishment of a consultative mechanism to prepare a new securities legislation), output targets (e.g., number of state-owned enterprises to be corporatized), and impact targets (e.g., increased foreign direct investment inflows). Therefore, the usual application of 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 reform activities. It is essential to make explicit the assumed logical relationship between the policy context and PBL, to insure 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 IFIs and the government.⁵

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, but rather contribution to policy reform. 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 with a readiness to adapt to changing conditions. The following questions can be asked with respect to the 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?

POLICYMAKING PROCESS: FROM DESIGN TO IMPLEMENTATION

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 policymaking 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 policymaking 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 the nature of the reforms or programs of action should be, what resources will be allocated to reforms and when, and initiation of the reform process and its implications for implementation.

Policymaking 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 policymaking process can constrain the policy options available to individual policymakers, e.g., executive and government agencies or central agencies such as a Ministry of Finance. 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 policymaking does not provide sufficient basis for building the necessary consensus to support implementation.

An appreciation of the policymaking process and its implications are often not considered or accommodated in PBL design. In this context the issue that may be posed is, should the time and effort be taken to understand and reflect the domestic policymaking 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 of experience seem to indicate that PBL design should indeed reflect an appreciation of the actual government system and policymaking process, formal and informal, in particular as related to PBL conditionalities, in order to insure 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 policymaking process would be able to generate the required legislation within the stipulated time horizon.

Example: In ADB's Thai agricultural program loan, a number of key roles and relationships needed 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 policymaking and budgeting).⁶

Example: In Vietnam, as noted, policymaking is a multilevel, multiplayer process involving central agencies, line ministries, provinces, communities, and the Communist Party. The formulation of implementable policies requires building up consensus for

policy change at 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 Vietnam should be understood in this broader context of the policy process. The government of Vietnam is composed of differentiated interests that must reach an accommodation within the framework of the formal and informal policymaking process on the nature, role, and design of PBL.⁷

Example: In Laos, a core conditionality in the second financial sector program loan 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 the prime minister's signature. However, obtaining the required signature turned out to be far more difficult and time consuming than anticipated.

Incorporating Policymaking into PBL Design

As suggested by the examples, an understanding of the policymaking process would seem to be useful and essential for the design of effective PBL. A better appreciation of the policymaking context, including how the process can constrain or modify the reform program (e.g., the steps and time to pass required legislation), is necessary in order to assess the feasibility of each proposed PBL initiative and respective conditionalities. Analysis of the policymaking 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 (e.g., technical assistance for institutional capacity building) related to the policy process.

Furthermore, identifying the key elements of the policymaking 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 within a reasonable time frame and perhaps the basis for contingencies in PBL design.

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 the 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; the National Economic and Social Development Board, Office of the Prime Minister, overseeing development strategy in general; 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 policymaking 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 take a set of inputs (e.g., information, decision) and transform it to create specific outputs (e.g., other decisions or actions).⁸ A policy process is simply a set of linked activities that result in a particular policy output (e.g., bankruptcy decree or legislation, or a policy to remove fertilizer subsidies). Understanding the actual policy processes related to particular PBL initiatives or conditionalities involves identifying:

- (i) Key decisions or actions required: necessary inputs for the decisions or actions;
- (ii) Actors: institutions, groups, 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; and,
- (v) Potential constraints that could have significant impact on the process: timing, content, etc., of key decisions/actions; factors likely to influence whether constraints materialize.

This information, which may be summarized in a policy process map,⁹ 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) that 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.

POLITICS OF POLICY REFORM: POLITICAL ACCEPTABILITY OF PBL

Policy reforms and PBL involve changing an existing set of policies and associated distribution of benefits, costs, and power alignments. As such, they 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 policymaking process. The role of politics in blocking/changing PBL has been noted earlier in the examples 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 fertilizer subsidies).

Resistance to reforms often becomes most pronounced during implementation, as their likely consequences—including threats to associated interests—become increasingly clear. 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 Vietnam from large state-owned enterprises for 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.

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 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., the government) with well-defined objectives, making independent decisions, and with the power to control the policy environment and therefore approval, initiation, and implementation of the reform process. It 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.¹⁰ In this process there are likely to be dominant players, but none are likely to have full control of the policy environment.¹¹

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.¹² Therefore, understanding the political acceptability of proposed PBL conditionalities is essential in order to assess their feasibility. In this context, technical analysis, e.g., the 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, i.e., not supported by a sufficient consensus of key domestic stakeholders, it will be difficult to implement and/or sustain. Governments generally need to have a level of confidence that 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, owing to complications from external pressures. As noted earlier, in the case of Sri Lanka, a new government was later elected with a mandate to restore fertilizer subsidies.

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 or municipal) that must own the policy matrix and implement particular conditionalities. Yet these institutions may have little incentive to do so, especially if they have limited access to resources from the PBL, which usually goes 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 insure 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 ADB's social program loan in Thailand, the Ministry of Finance signed off and committed to the conditions of the program. Yet, it could not insure that the Ministry of Education and the Ministry of Health would implement key conditions, e.g., those relating to decentralization.

A formal commitment by the government or Ministry of Finance, however genuine, may not be sufficient to insure the implementation of required PBL initiatives and conditionalities. There may be significant opposition and, therefore, 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 (for a broader discussion of government commitment, see annex 3 in Abonyi 2002). As noted earlier, the commitment of the government of the Philippines (meaning the executive branch, i.e., Office of the President) was not sufficient to insure the passage of required securities regulation code for the capital market development program loan, or 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 IFIs, 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 insure the relevance of PBL conditionalities and for achieving consensus.

Operational Implications for PBL Design

In an environment that may involve 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,¹³ and includes the following points:

- 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 likely to affect the proposed PBL in terms of its inputs, core activities, outputs, or outcomes?
- iii. What must be assumed about existing or future behavior and preferences of each key stakeholder in order for the PBL to be successfully approved, initiated, implemented, and lead to the desired outcomes?
- iv. What specific elements of the 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—or even block—the PBL process (e.g., 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 they be induced to support or at least not oppose the proposed PBL? For example, how can PBL design be modified to account for differing needs and preferences not presently accommodated, while insuring the basic contribution of PBL to policy reform?

An important means for incorporating such considerations into PBL design is through a process of stakeholder consultation. In this context, the strategy of consultation should be considered carefully. In general, there are two basic strategies that 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 less time is likely to be needed. However, the risk is greater of differences emerging as the details of PBL initiatives and conditionalities are made known during the policymaking process and implementation.
- ii. The more specific the focus of stakeholder consultations, the more difficult it may be to reach consensus, and more time is likely to be needed. However, once such consensus is reached, there is likely to be less risk of differences emerging later, e.g., during the policymaking process and implementation.

Example: In ADB's agricultural sector program loan for Thailand, 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 by some of the very same stakeholders consulted earlier. A key factor was that the details of the PBL, i.e., 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—and 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.

Source of PBL

If key elements of the policy reform, e.g., PBL conditionalities, originate primarily from the countries, 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 Vietnam agricultural sector program loan, deemed a success, was implemented in the context of domestically initiated reforms that were well underway prior to the PBL. Similarly, ADB's 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.

If the PBL or its key elements (conditionalities) originate externally, i.e., are IFI-driven, it may not be clear what form the internal political process and consensus building will take. For example, it may not be certain if there are domestic champions for reforms with sufficient incentive and power to forge the necessary political consensus. 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. It is likely or at least prudent to assume that the political process of consultation and consensus building may require significantly more time and effort in the PBL process. In the Thai agricultural sector program loan, difficulties involved popular political opposition and bureaucratic politics; in both Lao financial sector program loans, questions involved the actual commitment of government and the capacity to implement.

Scope of PBL

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 governments of developing countries for a step-by-step approach to policy reform and PBL, which although leading to more limited and slower reform, is generally easier to manage politically.

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. IFIs are generally seen as having a preference for wider scope in PBL, since this is seen as addressing a greater range of issues and reforms simultaneously.¹⁴

INSTITUTIONAL CONTEXT: FROM IMPLEMENTATION TO DESIGN

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 often limited recognition of the nature, role and relevance of the institutional context of PBL in their design. 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 ADB's Lao financial sector program loan, it became clear that the capacity of 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 its capacity with respect to PBL requirements turned out to be overly optimistic, significantly constraining PBL implementation.

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 (i.e., unimplementable) expectations and 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. Similarly, the seemingly more modest requirements of an effective system for the control of public expenditure and investment, essential for stable fiscal policy, can still be challenging. Requirements include, for example, establishment of multiyear public investment programs, 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 Kaufmann 1992).

Insuring 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 into 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, e.g., 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 the implementation capacity of a relevant set of key institutions.

Example: The State Bank of Vietnam signed off on ADB's Vietnam state-owned enterprise reform program loan. However, it is 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 bank to coordinate implementation, especially given that SOEs are under a wide range of ministries, provinces, and municipalities. Therefore, the bank's signing off with the best of intentions and commitment on the program could not unilaterally insure institutional interest and capacity in PBL implementation.

The identification of a possible capacity gap in PBL design may lead to the modification of the policy conditionalities to reflect institutional constraints on implementation. At the limit, it could postpone PBL. Alternatively, an understanding of the capacity gap may be used as an opportunity for including complementary capacity building initiatives, such as technical assistance, to increase the likelihood of successful PBL implementation. This may involve postponing the PBL until sufficient capacity is built for implementation. Alternatively, it may involve going ahead with the PBL and technical assistance 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 ADB's second Lao financial program loan, whose implementation has been hampered by institutional capacity constraints, a subsequent, parallel technical assistance 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 in terms of 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.¹⁵ 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.

Operational Implications for PBL Design

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

- i. Which are the core institutions involved in the implementation of key PBL activities, e.g., 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 be the specific capabilities of each institution 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; that is, 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 the

- existing or required linkages, including coordination and cooperation, among institutions to insure successful program implementation?
- vi. What are the gaps between the existing and required institutional capacity that could constrain implementation of particular conditionalities—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 inter-institutional linkages.

MUTUAL UNDERSTANDING: PBL AS JOINT PRODUCT

As noted previously, policy reform is essentially a domestic game wherein domestic conditions, requirements, constraints, preferences, and behaviors shape the process and outcomes of reform (Dollar and Svensson 1998). Ultimately, it is the responsibility of the 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 the IFIs play a supporting role by providing resources and advice. In this context, PBL as an element of policy reform is essentially a partnership between the IFI and the government. The government/IFI 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 the building and reaffirming of a government/IFI partnership. The initiation of the PBL offers the first opportunity for strong convergence or divergence over 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 Vietnam 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 Vietnam state-owned enterprise program, there was partial convergence of views after significant discussion and negotiation (e.g., over the concept of corporatization). In the case of the Lao financial sector program loans, there is a perception of limited convergence of views (e.g., on the leasing decree, bankruptcy decree, and 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 to prefer an incremental strategy of change. IFIs, on the other hand, often prefer a wider scope and a 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 government/IFI 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 IFIs, 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 a government/IFI partnership is a shared concept of the overall nature of policy reform and PBL. Reform is more than simply a set of discrete decisions and activities embodied in a PBL document. It is fundamentally a process of change—technical, political, institutional, and perhaps even ideological (especially in the case of transition economies)—which shapes actual PBL activities and outcomes. The establishment and maintenance of mutual understanding, including shared expectations between government and IFIs, is therefore a continuing requirement for an effective partnership—to be verified, reconfirmed, and maintained throughout the PBL process.

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 government and IFIs, including with respect to what each sees as relevant and feasible in policy reform and therefore with respect to 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: ex., sequence and number of steps involved in approval of a decree or passing of legislation; number of SOEs considered large, and therefore candidates for corporatization and inclusion in the PBL.

May be resolved by verifying and using a common database in PBL design: ex., identifying explicit details of the process for approval of a decree or passing legislation; examining available SOE data jointly.

- ii. Differences in interpretation of data arising from different models of reality (analytic frameworks), and/or differences in the meaning of concepts: ex., 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 a decree or legislation, rationale for the particular definition of what constitutes a large SOE, and assumptions about operational implications of corporatization.

- iii. Differences in values and preferences, or what is deemed as important: ex., preference for including/not including bankruptcy legislation in the PBL, preference for focusing on large SOEs instead of smaller SOEs, and on issuing of shares.

These differences generally cannot be resolved through more data or analysis, nor by clarifying rationale and assumptions. Their resolution requires discussion, debate, and mutual accommodation. The process can be assisted when both parties make key assumptions and their implications explicit.

Example: In the second Lao financial program loan, 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 Vietnam SOE program loan, the initial emphasis by ADB was on SOE privatization, or issuing of shares, 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 was not clear whether there was in fact complete congruence on the meaning and operational implications of this core program concept among all the key stakeholders involved.

Example: The Vietnam 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 the understanding of key issues involved in the PBL, e.g., trade policy, private sector role, and liberalization. There were basic differences in what should be the appropriate scope for the PBL, with ADB pushing a wide scope (e.g., 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.

Even seemingly minor issues can play an important role. For example, 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 IFI staff and government officials. As a consequence, problems could arise because of a 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 government participants to fully discuss their views and preferences in meetings held in a language in which they are uncomfortable. As a consequence, there may be a feeling on the part of IFIs that a clear, mutual understanding has been reached and proceed on that basis, whereas government representatives have significant reservations that do not emerge until much later in the

PBL process (during policymaking or the implementation stage) when managing such differences is more problematic.

A further source of constraint on mutual understanding may arise from the nature of the PBL instrument and process. This instrument may not be fully understood by government officials used to working with IFIs primarily on the basis of investment project loans that have fundamentally different characteristics and provide resources directly to implementing agencies. In many of the country interviews (e.g., Kazakhstan, Laos, Nepal, Thailand, Uzbekistan, and Vietnam), there was a general stress on limited experience and therefore a lack of familiarity with PBL instruments such as 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 insure 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; significant misunderstandings arise later in the process, leaving one side or both feeling that the consultations were not in good faith.

Example: This was reflected in earlier examples of differences in the second Lao financial sector program loan 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 IFIs' PBL activities, they have a potentially significant impact on building—or constraining—mutual understanding between IFIs and governments. They can act as de facto gatekeepers in the dialogue between governments and IFIs, influencing how issues are framed and interpreted. International consultants can facilitate or hinder mutual understanding and agreement between governments and IFIs, especially in their role in defining the policy matrix. For example, if such consultants have insufficient understanding of a country's 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 IFI consulting relationships, international consultants may not have sufficient appreciation of the IFIs' culture, strategy, and operational approach with respect to PBL, and to the more general IFI/country relationship of which the particular PBL is one aspect. This can also constrain PBL design, and impact on the broader relationship between the country/government and IFIs.

Consultants can also contribute to building agreement, acting as a conduit between IFIs and governments in PBL design. They can introduce sensitive issues to both sides that may be difficult for the government and IFIs 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.

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 an IFI may feel that it has a clear and correct, or

at the very least, sufficient understanding of country needs. The focus of the government, as noted, is likely to be on insuring both relevance and feasibility of reforms to the particular country context. Under these conditions, there may be basic differences in perceptions and preferences between IFIs and the government (e.g., issuing shares in Vietnam, the bankruptcy decree in Laos). The two sides may be using the same language but with quite different meaning, and talking past each other (e.g., publishing audit results of state-controlled banks in Laos, and the meaning of corporatization in Vietnam—both of which took a long time to reach shared understanding and agreement).

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 affecting policy reform and PBL. As noted, mutual understanding is required on these issues at the design stage, but the following fundamental questions must be borne in mind or at the very least revisited as the PBL process evolves:

- i. Why the PBL? What are the nature and specific characteristics of the policy issues that define the need for reform and for the particular PBL?
- 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?
- 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 policymaking process (including approval and initiation), and key institutional requirements for (and constraints on) implementation?

Where differences in perspective or position are identified, e.g., 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.

CONCLUSIONS

The role and operations of IFIs such as ADB have changed over time in response to emerging challenges. The critical constraint on development in the 1960s and 1970s,

and a focus of the initial role and operations of IFIs, was the lack of physical and social infrastructure—challenges that continue today. In responding to these needs, IFIs were primarily project lenders, 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 development. As a consequence, the role of IFIs has evolved, with policy and institutional reforms playing an increasingly important part of their operations, as reflected in the experience of ADB.

This means that PBL will play an increasingly important role in supporting development through policy and institutional reforms. However, in this context, experience with PBL has been mixed to date. For example, between 1987 and 1999, ADB made sixty-five program loans and thirteen sector development program loans. In spite of the effort and resources, a recent evaluation concluded that program loans and sector development program loans have made limited contribution to policy reform to date (ADB 2000). This is not unique to ADB, as the World Bank experience also reflects similar results (Dollar and Svensson 1998; Collier 1999). 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 IFIs would find PBL complicated and problematic. However, given the requirements of development, the challenge to IFIs is not necessarily to do less PBL, but to do it better.

It is the suggestion of this article that PBL requires a fundamental change in perspective: a shift toward a political economy approach to PBL. This, in turn, has certain general implications for IFIs 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 IFIs and governments, it is essential to insure a thorough understanding of the country and policy context, including an emphasis on political economy factors identified in this article. This requires by IFIs 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 preparation. 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 making 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 which may not be 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 country capacity building. Policy reform and PBL are about implementation: getting changes in place to yield desired improvements. In this context, beyond addressing particular policy issues, PBL involves improving institutional capacity for policymaking and implementation. Such capacity building for implementation 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 experience and issues related to policy reform and PBL would provide strong support for effective PBL that is appropriate to diverse characteristics.

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, 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.

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NOTES

1. Political economy context here refers broadly to the interrelationships between political and economic institutions and processes, particularly as related to policy decisions and reforms.

2. Policy-based lending refers here to any initiatives of international financial institutions such as the Asian Development Bank or the World Bank intended to support change, adjustment, or reform in policies, processes, or related institutions (see, for example, Michael and Bates 2003).

3. Perhaps with good reason: the experience with organizational change, for example in the U.S., a far more modest undertaking, is sobering. See for example Smith (2002) and Carr (1996).

4. Based on extensive discussions with senior officials throughout Asia.

5. The class of methods called structural models can provide useful support for representing the complexity of the policy reform context, the role and implications of PBL in general, and conditionalities in particular. This includes relatively simple but effective methods such as problem trees, objective trees, means-ends trees, and intent structures (see Jackson 1998 for a brief introduction; for an application see annex 3-5 in ADB 1999b). Where time and resources are available, systems simulation methods may also be utilized, such as those based on the language of system dynamics pioneered by J. Forrester (1971), available through simplified computer programs such as STELLA.

6. 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 the attending pressures of emphasis on speed of disbursement.

7. Based on interviews with ADB staff and officials of the Vietnam government. The political dimensions of policy reform and PBL is discussed in a later section; the focus here is on the policymaking process as a whole.

8. Outputs, in turn, lead to outcomes or impacts. For example, 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.

9. There is a wide 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).

10. 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, the beneficiaries of reform, even if potentially far more numerous, are seen as diffused and unorganized and therefore less able to play an effective advocacy role. See, for example, Haggard and Kaufman (1992) for a discussion of this issue. From the perspective of this article the key point is simply that the politics of policy reform is a key factor in PBL, and as such, requires explicit attention.

11. In different political systems the political process described here will differ in detail, but it is generally present in some form.

12. 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.

13. There are a range of methods/frameworks suggested to support analysis of the political context in general, and stakeholder analysis in particular (see, for example, ODA [1995] and Abonyi [1982]). On a suggestive methodology for assessing the political stability of decisions or outcomes, see the original conceptual work by Howard (1971) and its applications by Radford (1977).

14. The discussion here focused on the number of stakeholders involved. The intensity of preferences of the stakeholders, often a key factor in the politics of reform, was not considered. 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.

15. Experience with organizational change in advanced country settings such as the United States is instructive and puts the nature of the challenges facing developing economies in context. For example, it is estimated that more than two thirds of organizational change efforts fail, and where organizational culture is involved the failure rate may reach over 80 percent (Smith 2002; Carr 1996).

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