

# CHAPTER 3

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## DIMENSIONS OF SECTOR POLICY ANALYSIS

- | Sector Analysis Concerns
- | Linkages Between Policy Reforms and Development
- | Scope of Sector Analysis
- | Price Policy Context
- | Institutional Context
- | Reform Timing and Sequencing Issues

**A. Introduction**

The need for comprehensive sector analysis has long been recognized in ADB. This chapter looks at issues related to the sector, policy, and institutional environment in the context of policy-based operations. The linkages between policy reforms and development are also reviewed. Two fundamental sector issues are then discussed—price policy and institutional arrangements. The chapter concludes with an overview of reform timing and sequencing issues, including an introduction to the political economy dimensions of reform. These last points pave the way for placing the policy diagnosis in an analytical framework, to be discussed in the succeeding chapter.

**B. Sector Analysis Concerns**

The analytical framework for sector program assistance in ADB's 1987 review of program lending policies called for, among other things, assessments of issues such as: sector-specific policy constraints and their effects on producer incentives; domestic and border input and output prices; the degree of sector reliance on market forces; sector adaptability to changing circumstances; and the adequacy of institutional support and improvement needs (ADB 1987). Written in the mid-1980s, the review was primarily concerned with aligning price parameters, fostering market competition, and ascertaining the dynamic environment. ADB's policy continues to emphasize the medium-term development orientation of policy changes, rather than short-term macro-

stabilization measures. The review provided for a sector program focus—policy framework, investment program, and underlying institutional readiness—that closely relates to the policy–investment–institution trilogy of the sector-lending modality. It also set out the basic analytical issues involved in adjustment, further discussed in Chapter 6.

A decade later, the [1996 review of ADB's program lending policies \(ADB 1996\)](#) stressed the need for programs to be based on a comprehensive sector analysis and policy dialogue covering sector investment plans, institutional development needs, and social and environmental aspects. Moreover, some observations from the special evaluation carried out by the Operations Evaluation Department (OED) (ADB 2001) underscored the need for a thorough and comprehensive sector analysis.

Recognizing the importance of the interconnectedness of policy changes, program loans are generally considered as “slices of reform” implemented in a dynamic environment. As indicated by Collier (2001), for example, once macroeconomic misalignments have been addressed, growth is still usually constrained by many other factors. This characteristic emphasizes the importance both of understanding clearly that reforms are related to the rest of the economy or sector, and of identifying the most important binding constraints, which, in turn, implies appropriate selection of reform priorities. It also raises two questions about the program design: First, are the proposed policy and institutional reforms representative

of the binding constraints, given the circumstances? Second, what alternative policy and institutional reform measures are being considered that take into account the interlinkage of the subject reform area with the rest of the policy and institutional structures of an economy? Effectively addressing these questions reinforces the long-standing emphasis on a careful and comprehensive sector analysis.

### C. Linkages between Policy Reforms and Development

Reforms are ultimately concerned with more efficient and/or equitable use of resources, goods, and services. Both policy and institutional reforms have developmental, welfare-enhancement characteristics, which may involve the dismantling and reforming of existing underperforming institutions while, at the same time, developing, through investment-type activity, new institutional arrangements for future development. Ali (1990) makes the point that it is difficult to understand, or even have, good investment projects in a bad policy and institutional environment. The persistence of such a situation may reduce real returns to projects, implying that a high rate of return to policy reforms may be generated by correcting distortions to the policy environment. Ali suggests that investment projects and policy reforms are closely linked and that practitioners can employ similar analytical approaches.<sup>6</sup> Kanbur (1990) notes that many investment projects include conditions on policy changes in the sector being invested in (usually included as “assurances” in ADB project

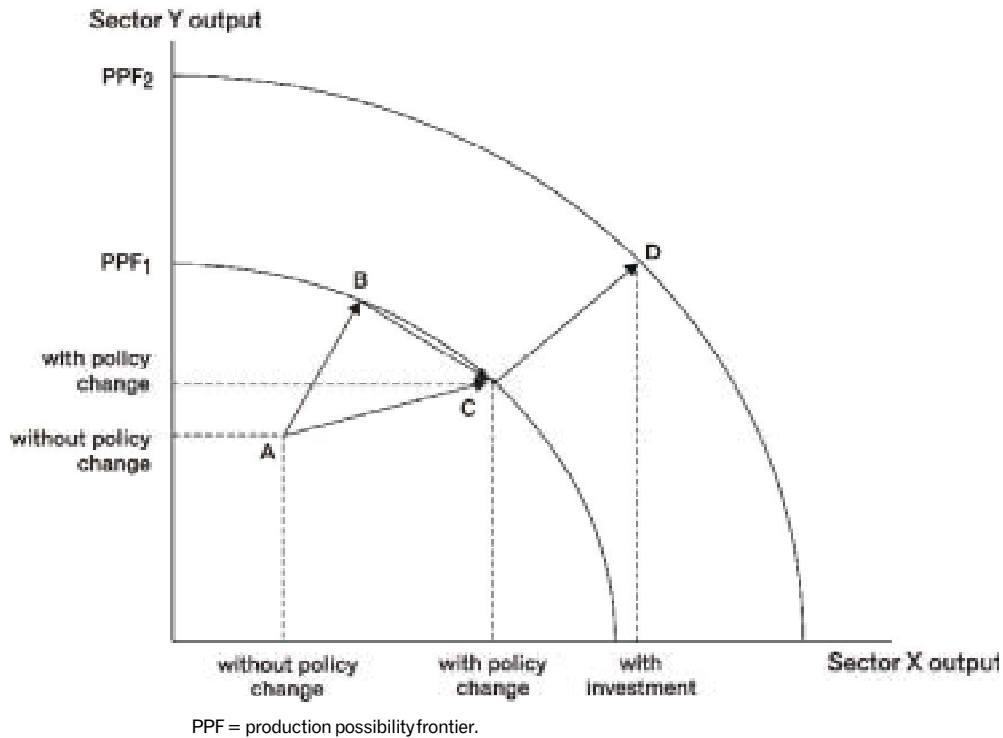
documents). Appropriate project-policy combinations can lead to an overall welfare improvement if these are complementary.

The relationship between policy reform and investment is shown in Figure 1 using a stylized production possibility curve. The total reform and development expectations are represented by a movement from point A on the prereform/development production possibility curve, to point D on the postreform/development production possibility curve. This can be decomposed into four elements.

- First, reforms that improve the efficiency of existing institutions and resource use result in movement from A to B, with A representing a state of suboptimal performance, to the present production possibility frontier.
- Second, a movement from B to C can be the result of, for example, price policy changes that will lead to a movement along the production possibility frontier.
- Third, a movement from C to D can be the result of investments in institutions or production.
- Fourth, a movement from A to C, and then to D, represents an idealized state that reflects a sequencing of reforms and development.

<sup>6</sup> Ali (1990) also observes that price policy reform can be viewed as a means of narrowing price distortions and the wedge between demand and supply. In this sense, the purpose of (price) policy reform is to increase efficiency through resource reallocation, which involves movements along the production possibility frontier, whereas a public investment project could be seen as adding to the supply of capital and moving the curve itself.

FIGURE 1: Effects of Programs and Projects on Production Possibility



**D. Scope of Sector Analysis**

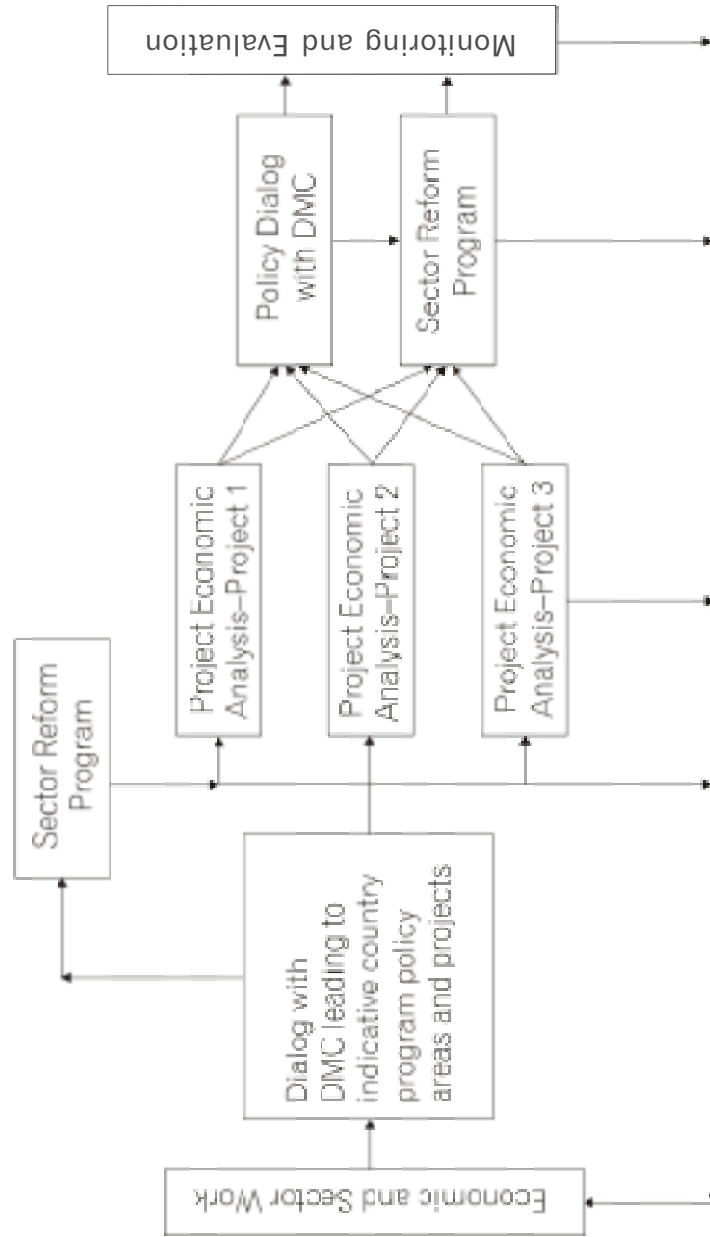
Program proposals can result from the analysis carried out as part of country studies, sector analyses, and dialogue with the government during country programming. They can also result from project analyses highlighting policy issues that are fundamental both to project sustainability and replication, and to program and project monitoring and evaluation (M&E). Figure 2 exemplifies the various stages in ADB operations that can give rise to policy issues. While project analysis, implementation, and M&E can all make valuable contributions to the

identification of policy issues, sector analysis is the logical starting point for conducting systematic analysis of the sector and of related development and policy issues.

A significant focus of sector analysis in ADB is to identify and understand constraints and their causes. While resource limitations and allocative choices are at the heart of an economic problem, policy-related failures may be a cause of the problem. Examples are provided in Box I.

To identify and understand the range of market, nonmarket, and institutional

FIGURE 2: Stages in ADB Operations Giving Rise to Policy Issues



DMC = developing member country.

Source: EREA, Asian Development Bank.

CHAPTER 3

**Box 1: Policy-Related Economic and Institutional Problems  
Identifiable in Sector Analysis**

- Differences between the market and opportunity costs of a resource due to government price management (e.g., minimum wages).
- Barriers to market entry due to government-imposed subsidies, tariffs, quotas, nontariff barriers, and public enterprise dominance.
- Investment disincentives due to poorly defined and unsecured property rights.
- Failure to correct negative externalities due to lack of defined standards and their enforcement (e.g., pollution).
- Limited access to and supply of resources available for development (e.g., underdeveloped capital markets).
- Uncompetitive markets and inefficient provision of goods and services (e.g., lack of monopoly regulation).
- Failure of private markets to provide a good or service.
- Failure of markets to provide information (e.g., prices or product safety).
- High transaction costs among economic agents and markets.

Source: EREA staff, Asian Development Bank.

issues that affect sector performance, a systematic analysis is required. A relevant scope for sector analysis of issues to support program lending is described in the 1996 review of ADB's program lending policies (ADB 1996). Elements of the discussion are included in the following summary of the elements of a sector analysis:

- **Macroeconomic Context and Country Management.** This includes (as described in Chapter 2) economic projections, macroeconomic assessment, national development strategies and plans; public sector resource management; overall social conditions; and country poverty assessment including income distribution and patterns of poverty.
- **Sector Description.** This includes assessment of the sector's role, features and resources, changes and trends, the demand for sector goods and services, the overall supply of sector goods and services including input and output system efficiency,

government policies, reform agenda and key institutions.

- **Markets, Prices, and the Incentive Structure.** This relates to a specific industry's conduct, performance and structure; policy-caused price differentials such as those from taxes, subsidies, and monopolistic practices; market underperformance or failures; influences on transaction costs, profitability, and competitiveness; response to the global context and international trade; and assessment of private sector needs and constraints.
- **Institutional Performance.** This concerns the role, conduct, and performance of government and public institutions, including: the institutional framework; public goods and service provision and capacity; fiscal and public expenditure incidence and impact; the state of the enabling and regulatory environment; and institutional and nonmarket failures, such as bureaucratic malfunctions and corruption.

A distinction needs to be made between two major types of market-related policies—price policies that can fundamentally affect enterprise returns as well as economic efficiency, and institution-related policies that affect the facilitation and regulatory role of government, and the alignment of institutions in relation to users. The next two subsections highlight specific issues in price policies and in institutional policies that should be assessed at the sector level.

### E. Price Policy Context

Differing policy objectives can have profound effects on the allocative efficiency of resources and distribution

that can lead to changes in overall welfare. So, policy implications of reforms are of interest to a wide range of domestic and international stakeholders as well as development practitioners. The economic soundness and impact on stakeholders of existing and alternative policy environments need to be assessed in relation to each other. Box 2 provides examples of conflicting policy alternatives in the agriculture sector. The examples of policy alternatives provided in Box 2 are often achieved through the use of different price policies. Box 3 provides examples of how the use of price policy in agriculture can affect different stakeholders. Further, it shows that policy alternatives are often mutually

#### Box 2: Examples of Conflicting Policy Alternatives in the Agriculture Sector

- Promoting resource allocation efficiency in agriculture (and the economy) to raise productivity and competitiveness.
- Accelerating economic growth through expansion and support for agriculture.
- Reducing malnutrition and increasing rural incomes by emphasizing expanded small farmer production and employment creation for the landless.
- Improving food security through price and supply stabilization and extensification.
- Promoting self-sufficiency and price control to maintain political stability.

Source: Adapted from P. Streeten. 1987. *What Price Food?* Macmillan Press.

#### Box 3: Examples of Price Policy Trade-Offs in the Agriculture Sector

- Price controls to lower consumer prices can reduce farmer incomes (depending on elasticities).
- Raising producer prices can raise the consumer cost of living.
- Input subsidies may increase production but distort resource allocation and weigh in on fiscal resources.
- Food subsidies may lower consumer prices but weigh in on fiscal resources.
- National food self-sufficiency through government traders (monopolies) can result in allocative inefficiencies and welfare losses, and undermine sector growth.
- Production extensification and intensification can have negative environmental externalities.

Based on: P. Streeten. 1987. *What Price Food?* Macmillan Press.

exclusive, implying efficiency and distribution trade-offs.<sup>7</sup>

Project sector assessments and economic analysis routinely identify price differentials resulting from market structure and policy choices, as reflected in the divergences between financial and economic prices. In many cases, the price differential and its implications may be tolerable within the context of economic performance. However, when these differentials are so large that they

undermine efficient allocation of resources—as when production is subsidized but prices are controlled—then policy changes may need to be considered.

Tables 2 and 3 summarize examples of the causes of variation in financial and economic values in the context of agriculture and rural development. These tables indicate that the extent of differences between values is usually a reflection of the policy environment and

**TABLE 2: Factors Causing Economic Prices to Exceed Financial Prices**

Factors Causing Difference	Examples from Rural Development and Agricultural Projects
Taxes on output	<ul style="list-style-type: none"> <li>• Export duties and taxes</li> <li>• Controlled food prices for consumers (depresses producer price)</li> </ul>
Subsidies on inputs	<ul style="list-style-type: none"> <li>• Fertilizer prices to farmers</li> <li>• Nonmarket-based credit</li> </ul>
Foreign exchange premiums	<ul style="list-style-type: none"> <li>• Overvalued foreign exchange depresses output earnings and raises input costs (in domestic currency)</li> </ul>
Price ceilings	<ul style="list-style-type: none"> <li>• Users of water at a tariff that does not cover all capital, and operation and maintenance costs</li> </ul>
Positive externalities	<ul style="list-style-type: none"> <li>• Agricultural project production encourages growth in agro-processing</li> </ul>

Source: EREA, Asian Development Bank.

**TABLE 3: Factors Causing Financial Prices to Exceed Economic Prices**

Factors Causing Difference	Examples from Rural Development and Agricultural Projects
Subsidies on output	<ul style="list-style-type: none"> <li>• Produce bought at high fixed price by state marketing board</li> </ul>
Taxes on inputs	<ul style="list-style-type: none"> <li>• Import duties on agrochemicals and equipment</li> </ul>
Foreign exchange discounts	<ul style="list-style-type: none"> <li>• Undervalued foreign exchange increases output earnings and depress input costs (in domestic currency)</li> </ul>
Minimum wages	<ul style="list-style-type: none"> <li>• Financial price of unskilled/surplus labor is higher than its economic price</li> </ul>
Negative externalities	<ul style="list-style-type: none"> <li>• Environmental damage</li> </ul>

Source: EREA, Asian Development Bank.

<sup>7</sup> This example is discussed in further detail together with approaches to analysis in Chapter 5 and Case 1 in Appendix 3.

the choices being made by policy makers. In Table 2 where, for example, economic prices are higher than financial prices of food products due to a tax, these can reduce the incentive to produce and suggest a policy regime favoring the consumers. Conversely, a subsidy on inputs will cause their economic prices to exceed their financial prices, reflecting a policy bias toward producers (Table 3).

As more economies adopt market-based systems and freer trade principles, the divergence between financial and economic prices has generally diminished. However, there can still be considerable variations between financial and economic prices across sectors, especially for nontradable goods and services within an economy, reflecting divergent sector policies and priorities. In most project cases, a degree of distortion exists, due to taxes and transfers, but at an acceptable level. In other cases, excessive biases in revenue collection or wasteful use of transfers create significant welfare inefficiencies. Where this is an issue for projects, the government may agree, as part of a project, to a limited set of new policies, such as improved tariff collection efforts or the reduction of a subsidy, to ensure sustainability of the project.

In general, projects assume a given environment of market or nonmarket imperfections and distortions, whereas policy-based loans are intended to change or remove these distortions. This means that understanding the extent and causes of financial and economic price variations is still needed in addressing the policy issues related to productive sectors. In cases where the sector

assessment and project analyses identify policies that are disruptive to market processes—and, for example, significantly affect the financial or economic viability of a project—then policy reforms may be warranted to reverse losses.

The general implication is that reasoned and plausible analysis is needed to identify the positive and negative impacts of price policy on financial and economic performance of production and services, including the effects on different stakeholders. Once performance-affecting distortions have been identified, the extent to which stakeholders understand the trade-offs should also be assessed, since their influence can dramatically affect the momentum for reform.

## F. Institutional Context

### I. Institution Building and Reforms

Until the early 1980s, development efforts focused largely on filling the human and financial resource gaps. Throughout the 1980s and into the 1990s, the IMF and the World Bank emphasized “getting prices right” through price-focused structural adjustment. Such reform measures are still needed to address, for example, specific price constraints where they are binding. But, the nexus between economic management, institutions, and development is receiving greater focus.

The changing focus stems from the crucial role that institutions play in the functioning of markets, especially in the transmission of market signals, and in

providing appropriate incentives to economic agents. More importantly, institutions allow major elements in the policy reforms to be sustained over the medium term. While policies can have a significant influence on institutions, institutions, in turn, can also affect the form and adoption of policies. Stiglitz (1998) suggests that development is about transformation of society, and institutional changes are part of this transformation. So, countries will have to build capacity as well as reform and replace the traditional institutions that will be superseded in the development process. In this regard, three elements need to be recognized: (i) the historical and social context of institutional changes; (ii) that changes take place as a process of evolution and adaptation; and (iii) that such changes involve broad participation and consensus building.

Viewed holistically, an institution is a collectively shared, self-sustaining system of beliefs about the “rules of the game” in a society, the enforcement mechanisms, and the organizations that support market transactions and public goods delivery. These rules, mechanisms, and organizations are important as they determine the incentives for political, social, and economic exchanges, including such aspects as property rights, regulations against fraud and anticompetitive behavior, the rule of law, and the judiciary (Rodrik 1999). When such basic rules do not function efficiently, market opportunities are limited by institutional constraints such as: high transaction costs arising from asymmetric information; poorly defined and weakly enforced property rights; and barriers to market entry for new

participants. A vital aspect of the reform process is therefore the realigning of institutions, including policy changes geared toward improving institutional arrangements that determine the context in which policies are made. Improvements in institutions that lower transaction costs, manage risk, and enhance competition are also key (World Bank 2002a).

The World Bank’s *World Development Report 2002*<sup>8</sup> highlights the importance of institutions by asking why some markets are rewarding for some groups and not for others, and why some are inclusive and well integrated while others are localized and segmented (World Bank 2002a). The reasons for these performance variations are explained in terms of the rules, mechanisms, and organizations. The effectiveness of institutions determines the extent to which people, from the rich to the poor, have the opportunity and incentive to be involved in gainful market activity (World Bank 2002a). Stiglitz (2000) notes that “in assessing institutional arrangements, one has to evaluate not only the institutions that exist, but those that are absent as well.” These points underscore the need for institutional responses for providing appropriate social insurance, enhancing industrial relations, overcoming labor-market rigidity, expanding access to information and

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<sup>8</sup> The *World Development Report 2002* provides a comprehensive description of the facets of institutions that need to be understood, including firms (from farmers, to the governance of firms, to financial systems), government (political institutions, the judicial system, managing competition, and the regulation of infrastructure), and society (norms and networks, and the media).

education, and streamlining title registration and business licensing. Stiglitz (2000) further adds “from the perspective of policymakers, the most important issues are how to encourage the creation of good institutions and how to design institutions that can change as the environment changes. Both questions demand careful thought about organizational design and sequencing of reforms.”

An implication of institutional policy change is the complexity of reforms that must be understood within the context of individual economies, including the institutional environment and arrangements<sup>9</sup> (Klein 1999). Policy change is also a process that takes place over time, with the cumulative effect emerging from the complementary and mutually supporting development of other institutions. So, the time dimension of institutional change needs to be better appreciated, as the time lags between initiating changes and their ultimate impact can be significant, especially at the lower layers of the hierarchy of institutions. The longer-term consequences of such institutional underpinnings should not be underestimated.

In addition, changes in one set of policies or institutions typically lead to the need to overhaul related institutions. For example, the problems of corporate

debt overhang and insolvency have led to measures for financial liquidation and bankruptcy proceedings that subsequently required changes in existing laws and the judicial system. Given their context specificity and local inter-connectedness, the idea of international best practice in institutions has limited relevance, with few cases of “one size fits all” in institutional policy and design, especially in the context of institutional structures that lead to economic growth and poverty reduction.

Strategically, institutions need to be developed with local involvement, using local knowledge, hands-on experience, and even experimentation (Rodrik 1999). Aoki (2000) notes that a wide variety of arrangements, both formal and informal, can be considered as “institutions” for as long as economic agents take them to be relevant, from statutory laws and regulations to unwritten rules and codes of behavior based on social ties and trust. Similarly, a formal regulatory body is only an effective institution if it can enforce sanctions on these agents. This suggests that only institutional arrangements that are mutually consistent or reinforcing may be viable and sustainable in an economy. So, the outcome of policy advice is determined by the interactions of the strategic expectations of stakeholder groups.

With regard to the capacity-building aspect of program design, institutional development can only emerge when stakeholders are willing to bring this about; when they coordinate their choices; and when they share a consensus on the reform measures to be adopted.

<sup>9</sup> Institutional environment refers to the background/institutional constraints, or rules of the game that guide agents' behavior. Institutional arrangements refer to the governance structures designed to mediate particular economic relationships, which can include business firms, long-term contracts, public bureaucracies, and nonprofit organizations.

Consequently, policy change that deals with or affects institutions involves a relatively complex process that frequently evolves in conjunction with development efforts.

Bringing together some of the above strands, the study of institutions, as part of sector analysis, should focus on fostering institutional arrangements and innovations that address causes of constraints and failures. The ultimate aim is to induce coordination and cooperative solutions in implementing policy changes. In turn, this will help mitigate conflict and realize mutual gains. Second generation reforms, for example, will require the design of new sets of institutions and institutional arrangements that should ensure appropriate incentives to economic agents and organizational structures that are “incentive compatible.” With the aim of aligning governance structures with opportunities and incentives, reform programs may also be designed to minimize institutional constraints, coordination failures at various levels of government, transaction costs, and asymmetries in wealth/assets and information. Thus, the interaction between first and second generation reforms needs to be clearly understood while the timing and sequencing of respective reforms should be carefully considered (see Chapter 3.E). In this context, policy analysts and makers need both to adopt a long-term view of development and to undertake detailed diagnosis that will help in building local institutional capacity.

Throughout the 1990s, ADB policy operations increasingly addressed institutional reforms. The need to

address institutional development and capacity limitations in reform situations is explicitly acknowledged in core program loan reports, as summarized in Table 4.<sup>10</sup> A theme that runs through each of these loans is the absorptive capacity of existing institutions to deal with economic and social development. However, absorptive capacity is a broad term and various perspectives need to be considered if capacity-building initiatives are to be appropriate. In this context, absorptive capacity refers to the policy-making environment; the managerial and administrative capacity of institutions responsible for translating policy into the delivery of programs and services; and the technical capacity of institutions. With current practices in mind, the following subsections summarize generic points in assessing the institutional framework, as well as issues in the managerial, technical, and absorptive capacity of institutions.

## 2. Understanding Functions and Performance of Market-Related Institutions<sup>11</sup>

In its discussion of market institutions, the *World Development Report 2002* provides a useful basic framework for understanding the functions and performance that could become the basis for effective institutions. Three aspects

<sup>10</sup> For example, Abonyi (2002) identifies variability in the assessments of certain reform programs (e.g., VIE: State-Owned Enterprise Reform and Corporate Governance Program), not least from the point of view of reaching a mutual understanding between the government and the international financial institution as to the approach to and content of the reforms.

<sup>11</sup> This subsection draws heavily on World Bank (2002a) (p. 8).

**TABLE 4: Institutional Issues Considered in ADB Program Loans**

Loan	Example of Capacity Issues Addressed	Type and Means to Address Capacity Limitations
VIE: State-Owned Enterprise Reform and Corporate Governance Program	Strengthening institutional and regulatory framework for state-owned enterprise reforms	Policy development and coordination: Individual steering committees integrated to identify priorities and sequencing of reforms, monitor progress, mobilize support.
MON: Financial Sector Program	Weak commercial banking skills and inadequate financial systems	Policy development, market-related institutions, and public support service efficiency improvement (management and technical): Banking supervision, regulation standards and procedures development, skills development through long-term advisory support, and on-the-job training.
VIE: Financial Sector Program	Development of financial market infrastructure to facilitate private sector participation including commercializing and modernizing banks, secured lending, and capital market development	Market-related institutions and public support service development (management and technical): Development of the legal and regulatory framework including passage of legislation, implementation of asset valuation, collateral security and registration systems, accounting and audit system establishment to international standards, and information disclosure.
THA: Social Sector Program	Facilitation of structural reforms, mitigation of short-term impact of structural reform, social service efficiency improvement, and decentralization	Facilitation of structural adjustment reforms and public service development (management): Start of decentralization with specific assistance in mitigation for displaced workers and education support for low-income families, planning and management systems and capacity, monitoring systems, and labor market information flows.
INO: Financial Governance Reforms	Fiscal management, and financial institution strengthening in terms of information disclosure and regulation	Nonmarket and market failure containment, policy development for market-related institutions, and public support service (management and technical): Management and technical training in central bank and nonbank financial services supervision, skills development in risk assessment and new financial services, and accounting and performance audit skills development.
KAZ: Pension Reform Program	Pension system efficiency and sustainability of market and nonmarket systems	Policy development, market and nonmarket institutional development to address service efficiency and sustainability: Reorganization and establishment of public institutions, system expansion, improvement of management and administration capacity, and technical capacity building.
PAK: Trade, Export Promotion and Industry Program	Implementation of trade liberalization, trade facilitation restructuring, and privatization	Support for trade liberalization policy, development of market-related institutions, and nonmarket support services: Modernization of the management and technical aspects of customs administration, and efficiency improvement of the export promotion board.

Sources: Asian Development Bank, reports and recommendations of the President of above loans (see Appendix 1).

are highlighted: the channels of information that exist to inform current and potential new participants about market conditions and goods; the extent to which property rights and contracts are defined and enforced as the basis for determining access to resources and income; and the extent to which institutions increase or decrease competition in markets.

**a. Channels of information**

Good information flows help formal and informal businesses identify production and trading partners, as well as compare and identify possible returns in terms of size, risk, trustworthiness, and creditworthiness of potential partners such as suppliers, producers, buyers, borrowers, and lenders. Each of these partners, as part of the institutional setup, can play a role in the collection, production, analysis, verification, and dissemination of information and knowledge. Public or private institutions, such as banks, can perform this role for specific purposes. The extent to which the various participants have access to sufficient information determines the likelihood of participation. Development-needs assessment is based on an analysis of: the extent to which formal and informal institutions collect, provide, and disseminate information as a matter of policy; the costs of collecting information; and related capacity limitations.

**b. Property rights and contracts**

Understanding and clearly defining rights to assets and income and being able to protect agreed rights is essential

for market development. The rights of the private sector in relation to the state, and foreign participants in relation to domestic participants, as well as the ability of institutions to handle disputes and enforce contracts, have a crucial bearing on market and participant confidence. Not only must corporate and SME investors and innovators be assured of their rights, but also the poor, risk-averse investors who stand to lose what little they have. The focus of assessment is likely to be: constitutional provisions; the judicial system; other social networks and mechanisms for rights determination, adjudication, registration, and settlement; and the costs of enforcement.

**c. Competition in markets**

The value of competition through equal opportunity is the incentive for participants to do better and channel resources to their best use, compared with systems that depend on social and political connections. On the one hand, this requires institutions that facilitate competition, by providing key market entry information and rules of operation and by minimizing transaction costs. On the other hand, institutions play a key role in regulation that ensures fair practice from the point of view of all participants. Problems arise in over- and under-regulation of markets, resulting in exclusion to the benefit of a few participants in the former, and exploitation and other negative externalities in the latter. Assessments on the appropriate level of market regulation will help determine the extent to which public and private

regulatory institutions help or hinder competition.

Collectively, the above aspects determine critical policy-related matters including the distribution of assets, incomes, opportunities, and incentives for market participants, as well as the efficiency of market transactions. The performance of these institution-dependent economic variables determines the pace of improvement of productivity, economic growth, and poverty reduction.

### 3. Managerial and Administrative Capacity of Institutions

Assuming that the political commitment exists to pursue a reform path, the next areas to be assessed are the nature, role, and abilities of the institutions responsible for implementing policy changes. When policy reforms address enterprise underperformance problems, such as poorly managed public enterprises, in favor of emerging market-based opportunities, reforms can move the management of activity to more appropriate public, or private, institutions. When reforms address the delivery of public goods and services, assessment of the capacity of institutions to deliver in the context of programs will be as important as project institutional assessments, if not more so, because of their often sector-wide effects. Box 4 outlines key elements of managerial and administrative absorptive capacity that require an understanding for the purposes of policy operations.<sup>12</sup>

### 4. Technical Capacity of Institutions

Closely related to managerial and administrative capacity is the issue of technical capacity to implement reforms. Again, where reforms are proposing realignment of responsibilities between institutions, whether public or private, appropriate technical procedures and a minimum level of technical capacity must exist or be developed for institutions and reforms to be credible. For example, a realignment of public services may require substantial investment in technical training or reorientation from direct service provision to a support and regulatory function. Decentralization often requires not only massive fiscal decentralization, but also extensive and costly investments both in local skills training for administration of funds and the technical aspects of planning, and service delivery that were previously handled by central government staff. Such capacity building needs to be integrated with the adjustment effort. Box 5 summarizes technical capacity considerations for policy operations.

### G. Reform Timing and Sequencing Issues

#### I. Economic Considerations

Economic theory suggests that an agent takes one action that leads to the highest marginal returns in the circumstances. This theoretical proposition should apply to all decision-making

<sup>12</sup> A comprehensive ADB source on issues and assessment of public administration is Schiavo-Campo and Sundaram (2001).

**Box 4: Factors to Consider in Assessing Managerial and Administrative Absorptive Capacity**

- Which are the core public institutions involved in the implementation of policies, specific steps (e.g., decisions/activities), and related policy conditionalities?
- What are the key capacity-related assumptions about implementation capacity for reforms, steps, and related conditionalities?
- How do decisions/activities relate to each other including required linkages, coordination, and cooperation among institutions?
- Do senior and mid-level management understand and support the reform?
- Is there an acceptable level of administrative integrity and accountability (has due diligence been conducted)?
- What is the extent of user confidence in target institutions?
- What capacity gaps exist and how can they be reduced, such as change of conditions, or strengthened capacity?
  - Is the organizational structure appropriate and what, if any, are the requirements for change?
  - Is there clarity in management and administrative roles and responsibilities?
  - Is management of public service personnel, including motivation, incentive, and reward systems, conducive to reforms and what is the likely responsiveness?
  - What are the prospects for institutional adaptability?
  - Have human resource development needs been assessed and determined?
- What are the implications for public expenditure, including distribution of fiscal responsibilities; interdepartment realignment/reallocations; short-term adjustment costs; medium-term savings; budget execution; changes/introduction of cost-recovery systems; and reporting, accounting, and auditing systems?

Source: Based on G. Abonyi. 2002. *Toward a Political Economy Approach to Policy-Based Lending*. ERD Working Paper Series No. 14. ADB, Manila.

processes—choosing among many feasible actions the one that makes the largest impact, or alternatively, choosing to tackle the binding constraint. Sequencing policy changes should also follow this first order of principles: What is the most binding policy or institutional constraint? Once determined, it should be removed first. Similar choice and sequencing processes in the fields of project management and engineering include such techniques as critical path analysis (ADB 1986).

The analytical principle that should govern the timing and sequencing of changes is always the concept of removing the binding constraint at the macro, meso, or micro level (Chapter 2.B). Indeed, as Collier and Gunning

(1999) observe, many structural constraints have to be addressed alongside macro stabilization measures. In this sense, stabilization and structural changes cannot be viewed in isolation or in a static way. Rather, they should be viewed as an interlinked and dynamic process. Easing an interlinked sequence of bottlenecks, therefore, is a dynamic process. Nevertheless, priority actions and measures should be established.

For example, in response to external and internal imbalance, the intended effect of macroeconomic stabilization is to restore balance and stability as fundamental to economic growth. At the sector and microeconomic levels, loss of domestic and international market competitiveness—due to chronic

**Box 5: Factors to Consider in Assessing Technical Absorptive Capacity**

- Existence of appropriate technical systems, procedures, and standards.
- Technical capacity of institutions and staff to carry out realigned tasks.
- Sufficiency of budgets to carry out realigned tasks.
- Adequacy of technical support for institutions and staff assuming new responsibilities.
- Adequacy of human resource development provisions for technical aspects.
- User confidence and satisfaction in technical aspects of service delivery.

Source: EREA staff, Asian Development Bank.

inefficiencies in factor use and low productivity, falling export prices, or rising imported raw material prices—may require more specific structural reform action as a subset of first generation reforms.

Similarly, Agenor and Montiel (1999) indicate that the sequential order, timing, and optimal pace of specific macroeconomic and structural reforms and their interrelationship are important for conceptual and practical reasons. In terms of, for example, the financial sector, they suggest that fiscal imbalance and control should be addressed as a prerequisite to undertaking the full range of financial sector reforms, such as liberalization of the domestic financial system and removal of capital flow restrictions, in order to avoid the risk of inflation and debt overhang which may, in turn, result in capital flight. Further examples of sequencing considerations for financial sector reforms are provided in Box 6.

In the context of ADB operations, sector-level reforms usually assume that first generation reforms have already been implemented. If they have not been, macroeconomic constraints will likely

influence the success or failure of policy operations. For this reason, it is necessary that ADB program loan reports include a realistic and pragmatic assessment of the extent to which earlier reforms have been effectively implemented. Table 5 shows examples from three of the core program loan reports as to how timing and sequencing issues arose and were addressed.

**2. Political Economy Dimensions**

The timing and sequencing of policy change should not, though, be viewed as a mechanistic process. The timing and sequencing considerations need to go beyond the technical aspects of “optimal policy design,” and several other considerations need to be borne in mind. These include the related magnitude of economic and social dislocations—the adjustment costs and the political feasibility of a policy change.

Collier (2001) stresses the need for a diagnostic procedure that sufficiently analyzes the range of possible binding constraints on growth and the proper sequencing of priorities. Furthermore, he observes that policies depend on the balance between political constituencies,

**Box 6: Examples of Sequencing Considerations in Financial Sector Reforms**

- A sound fiscal position is needed to deal with potential bad loan situations and to ensure that franchise banks maintain their value.
- Establishing and deepening the domestic money and securities markets are necessary to develop the domestic banking system and to ensure that financial opening does not lead to excessively high interest rates and overintermediation.
- Policies that safeguard property and promote investor confidence are necessary before removing capital flow restrictions to avoid capital flight, especially where there is debt overhang.
- Of particular importance is the liberalization of the enabling environment for foreign direct investment (FDI), trade, and finance to raise investor confidence, and to ensure that the benefits of FDI can be realized (know-how transfer and improved commercial openness).
- The liberalization of and increased competition in domestic financial systems (freeing domestic interest rates, use of indirect instruments for monetary control, etc.), as protected by adequate accounting-standards supervision and prudential regulation, should occur before the capital account is opened to avoid capital flight, a balance-of-payments crisis, and misallocation of external funds to under-performing investments.

Source: Pierre-Richard Agenor and Peter J. Montiel. 1999. *Development Macroeconomics*. Second Edition. Princeton University Press.

with many stakeholders and electorates having insufficient information to influence and control their leaders. Four areas are identified as bottlenecks: lack of information, lack of a way to turn information into knowledge, lack of capacity for analysis, and lack of capacity for policy design. Assuming that international financing institutions have the capacity for analysis and can assist with design, it is essential that they: encourage standards of good practice in terms of gathering and sharing information; help in analysis, design, and dissemination of policy options; and encourage lender-borrower collaboration, based on partnership as opposed to coercion. The practices are consistent with issues such as inclusion, empowerment, and civil participation as they relate to policy-based operations.

In considering the political economy dimensions of adjustment, even at the sector analysis stage, it is necessary for the policy analyst to: (i) sift through

various policy alternatives and paths to search for a “least-cost” solution, as well as design an acceptable package and sequence of reforms; (ii) test the political reaction as a means of assessing the demand for changes from both active and latent constituencies, and improve understanding of the nature of policy reforms; and (iii) identify the likely adjustment process and related costs as a way to assess the different dimensions of reforms (see Chapter 6). The last point is also made by Collier (2001) who indicates that in countries with inadequate policies, there can be a large latent constituency for policy reform.

In discussing the feasibility of policy reforms, Sadoulet and de Janvry (1995) suggest that “A policy that does not pass the test of political feasibility is a utopian proposition.” Made in the context of introducing quantitative development policy analysis, this highlights the need to understand the political as well as the economic and

**TABLE 5: Economic Timing and Sequencing Issues in Program Loan Reports**

RRP	Key Context/Issues	Justification for Reform Timing/Sequencing
VIE: State-Owned Enterprise Reform and Corporate Governance Program	Viet Nam's gross domestic product (GDP) growth dropped by nearly half from 8.2% in 1997 to about 4.4% in 1998. This decline was partly caused by the regional financial crisis, declining foreign direct investment disbursements, and a sharp drop in exports. The Government reacted by controlling public expenditure and monetary growth, devaluing the dong on two occasions, and introducing import bans on major consumer goods.	Following the immediate stabilization measures, the Government recognized that sector reforms would have to be significantly deepened for Viet Nam to effectively cope with the consequences of the regional crisis and to reestablish sustainable growth. To sustain growth in the industry sector, specific reforms were intended to: (i) create an enabling environment for foreign investment; (ii) support the development of private enterprises; (iii) accelerate state-owned enterprise reform by strengthening the institutional framework for supporting corporatization and commercialization of state-owned enterprises; (iv) introduce a system of improved corporate governance; and (v) enhance labor mobility.
THA: Social Sector Program	After a GDP growth of 8.7% in 1995, the Asian financial crisis resulted in zero GDP growth in 1997 and an anticipated negative growth rate in 1998. The crisis was primarily traceable to an exchange rate policy of tying the baht to a basket of currencies heavily weighted by the US dollar, combined with imprudent lending policies and inadequate supervision of banks, especially private financial companies.	Initially, the Government proceeded with its economic reform in five areas: (i) monetary and fiscal policies, including macroeconomic targets and management to restore macroeconomic stability; (ii) financial sector problems faced by financial institutions; (iii) public administration, including reforms of state enterprises and the civil service; (iv) industrial restructuring to boost overall industrial competitiveness; and (v) new initiatives in the social sector. Social sector policies were seen as important in terms of their timing to mitigate the negative social consequences of the crisis and the possible hardships resulting from economic reform/restructuring measures.
INO: Financial Governance Reforms	Although economic performance was largely on track in the first half of 1997, and despite the apparent strong macroeconomic fundamentals, the rupiah began to weaken in the second week of July 1997, following the floating of the Thai baht. A number of factors such as the level of foreign debt, heavy investment in the property sector, weaknesses in supervision and regulation of the banking system, governance problems, uncertainty about political succession, and emerging social tension eroded confidence and contributed to a large decline in the rupiah.	Following the unfavorable reception of the draft 1998/99 budget, the Government entered into a strengthened stabilization program with the International Monetary Fund in mid-January 1998 with an emphasis on fiscal stabilization measures. As the crisis had adversely affected the financial sector, the program loan was formulated to restore confidence through financial governance reforms. Reform measures consisted of: (i) improving financial governance practices, (ii) increasing the disclosure and transparency of financial information, and (iii) strengthening the legal and regulatory framework of the financial sector.

RRP = report and recommendation of the President.

Sources: Asian Development Bank, program loan reports of above loans (see Appendix 1).

social dimensions of reform. Abonyi (2002) also makes the point that effective policy operations require an appreciation that policy reform is a “domestic game,” even when initiated externally. Thus, policy making and associated processes of economic liberalization, such as the pace of privatization, need to be pragmatic and to closely consider influences that constrain macroeconomic and sector policy choice, including political acceptability. Reforms and policies must be consistent with the broader policy environment.

Implementing institutional changes, such as decentralization, may take even longer, given entrenched vested interests let alone the logistical challenges of such a change. Again, the time lags between initiation of change and implementation should not be underestimated. Sector analysis can play a major role in assessing the readiness, interest, and time involved in such changes and can initially assess the program implications.

The above points stress that institutions should not be treated as “black boxes” that readily transform inputs into expected program outputs. A relevant design issue is the extent to which policy conditions can be formulated in a way that is compatible with adoption incentives. In this regard, an understanding of the political economy of the process of policy reform is essential (Abonyi 2002). According to Stiglitz (1999), many attempts at reform, at both the macroeconomic and sector levels, are less than successful because of their proponents’ misunderstanding of the foundations of

a market economy and of the basics of an institutional reform process.

It is therefore clear that policy operations and the responsibility of governments to implement sometimes far-reaching reforms require, most importantly, careful assessment of the capacity to adapt and the willingness and incentive to change (Box 7). To this end, sector analysis presents an opportunity to update the understanding of domestic institutional arrangements and of the political and policy development process; assess the time and resources needed to effect change and develop capacity; and minimize efficiency losses.

Overall, the determination of what the policy and institutional constraints are, including the most binding constraints, should be the task of sector diagnosis. Carefully done, this should include not only a descriptive review of what is going on in a sector, but also an analysis of why things are going on as they are and of what alternative measures can be taken to improve the prevailing policy and institutional context. This requires policy makers and analysts to have a good understanding of the workings of the economy and the sector. Appreciating the distinction between price and market reform issues on the one hand and institutional reform issues on the other, which second generation reforms typically address, can also be crucial in comprehending the context of specific types of reform and probable response, timing, and sequencing issues, as well as possible outcomes. Clearly, the timing and sequencing of policy changes constitute a complex and interlinked

**Box 7: Factors to Consider in Assessing Capacity to Adapt, and Willingness and Incentive to Change**

- What are the sector and institutional boundaries of the policies under consideration?
- Who are the key stakeholders with an interest in and likely to be affected by policy changes?
- How will political and development ideology, ongoing shifts and possible inertia, and their sources affect alternatives?
- What is the policy-making style of the client government (e.g., autocratic, democratic, consensus-based), including an understanding of the legislative and consultation processes, and, importantly, their timing?
- To what extent is the policy area a perceived priority by different stakeholders?
- Does a “reform champion” exist?
- Which stakeholders perceive decreases/increases in net benefits as a consequence of policy changes? What are the political implications and the way this is likely to be handled by the government, including compromises, compensation, and trade-offs? Do stakeholders have the power and means to influence the policy process (e.g., approval, block, implement) and the incentive to do so? How can opposers be induced to support, or at least, not oppose policy changes?
- What is the extent of technocrats’ and legislators’ supporting internal analyses of policy issues, and of their understanding?
- Is the timing of policy change appropriate in terms of the stability, reputation, and life of the government (e.g., progressive and reform-minded, new, mature, with agenda conflicts, transparent, intransigent, existence of policy vacuums)?
- What is the overall extent of political will and commitment, and what are the key motivating/deciding factors?

Source: Based on G. Abonyi. 2002. *Toward a Political Economy Approach to Policy-Based Lending*. ERD Working Paper Series No. 14. ADB, Manila.

system that has to be dealt with in a disciplined manner. That is, there are some fundamental principles that need

to be observed, and they have to be anchored in a rigorous sector diagnosis.