

CHAPTER 6

ASSESSING THE PROCESSES AND COSTS OF POLICY CHANGE

- | Understanding Reform Costs
- | Fiscal Environment for Policy Reforms

A. Introduction

Chapter 3 explained that, while price reforms are relatively discrete and can be rapidly implemented through a well-functioning market system, constraints in transmission mechanisms and systems will affect benefit realization. For example, institutional realignment and reforms may take time to implement, affecting the benefits. Furthermore, one reform or program of reforms, or even a set of interrelated reforms, may have little impact on people's lives until the economy, related institutions, and the system of governance confer broad complementary changes. In this sense, procedures and expected outcomes for program loans should allow for a complex picture of reforms that may be expected to generate benefits over the medium term.

Chapters 4 and 5 discussed how results of analyses carried out through sector work, including supporting quantitative and qualitative analysis, provide diagnosis and simulation of the problems and effects of a given policy change. These analyses provide insights into the costs and benefits of policy reform, estimates of net welfare gains, as well as the distribution and intertemporal dimensions of a policy change.

On the assumption that policy problems have been analyzed, and options and expected outcomes identified, this chapter turns to issues related to the process of realizing desired policy outcomes.

B. Understanding Reform Costs

I. Time Dimensions

Reforms are often triggered in response to a crisis in economic or sector performance, or to declining and chronic underperformance of key institutions in terms of their efficiency and effectiveness. The reforms, in some cases, can also be seen as a shock—or at least a change—to the status quo arising from a change to the structure of the economy or the nature of institutions. Once a reform path is embarked upon, those affected often focus on the reforms themselves as opposed to the underlying cause that initiated the need for change. In part, this is because adjustment is a process that takes time, due to possible underlying structural rigidities and to response lags. Gainers may become impatient with expected improvements, while losers face immediate welfare decline and await reabsorption into a changing economy or access to alternative services. These situations occur because adjustment resulting from reforms is not always an instantaneous event due to issues such as asset fixity or missing complementary measures.

During the transition process, a dip can occur in aggregate output. In terms of their flow, the nature of these costs could be seen as similar to that of the capital costs in projects (although different in nature), in that they tend to be incurred up front. For example, the profile of net returns for policy reforms is similar to investment projects with negative net flows in the

early years, becoming positive once benefits are being realized in full. As with projects, whether the reform will generate a positive net present value at an appropriate discount rate depends on the extent of net benefits (Kanbur 1990, Ali 1990).

Reforms are often initiated when the economy or sector is already in a weak situation, and may have to be implemented in the face of, for example, limited fiscal resources to help the adjustment process. This may mean that the short-run rigidity in factor markets is exacerbated and a short-run decline in national output and income occurs before an overall increase materializes. There may, therefore, be a need to alleviate the short-term costs of adjustment or accelerate adjustment through budget outlays during this period of redistribution of income (Ali 1990).

The full extent of reforms, especially the institutional type, may extend well beyond the usual administrative life of a program loan (typically 3 years). An expectation by stakeholders of short-term tangible impacts may result in them limiting their efforts at the margin—especially if politically unacceptable losses of longer-term benefits or a possible policy reversal are expected (McMillan, Rodrik, and Horn Welch 2002). There may be a case for a more extended implementation time horizon for institutional programs with tranches being released when the institutions concerned are “ready” for the next phase as opposed to being driven by two or three closely spaced and difficult to absorb quick-disbursing tranche releases.

However, even when the administrative implementation period of policy-based loans is short and disbursements are quick, their full effects are often not felt until well after the program loan is closed. This is a feature that distinguishes them from projects. The dynamic nature of policy change effects also points to the need to use, to the extent possible, analytical methods that provide insights on the changes over time, rather than methods that simply suggest the static position.

The above points help in understanding what constitutes the costs of adjustment. First, there are the costs of the process of adjustment including structural and institutional changes, attendant resource reallocation and market realignments, dislocations, and reabsorption into new structures, for losers as well as gainers. Understanding this process and its implications is essential for policy makers, businesses, trading partners, and employees, among others, to assess the possible impacts and responses to policy changes. Many of these changes take place over time as adjustments occur and cannot be fully anticipated. As such, some costs, including the costs of uncertainty, are intangible while the benefits are often not immediately realized. Nevertheless, policy analysis can help assess these changes and identify, to the extent possible, the range of economic costs of the equilibrating process, both tangible and intangible, to the economy and to stakeholders.

Second, there are the real financial costs of the equilibrating or institutional change, such as compensatory payments,

loss of revenue, new recurrent costs, and other changes in public expenditure. Hence, while a price or institutional analysis may reveal a clear net welfare gain from policy reform, the tangible and intangible costs and processes of adjustment require close examination and clear articulation to help decision makers and stakeholders understand the likely process.

2. Distribution Implications of Reforms

Closely related to the lagged effects and intertemporal issues of policy change are the issues of resource reallocation that can occur as a result of reforms, the implications for intra- and intertemporal distribution of income, and compensation for losers—assuming that there is a net welfare gain for society (Ali 1990). This also implies that any aggregate effects will have to be disaggregated in terms of their incidences to different stakeholders. Here, it is important to note the two types of distribution effects of reforms:

- the intended effects that, if the reforms are successful, should be enduring in the prevailing environment; and
- the unintended effects that occur as part of the adjustment process, but that, over time, should be overcome and corrected as resource reallocation proceeds.

Where distribution effects arise, identifying who gains and loses from reform options is important, given the effects that distribution can have on the selection and support for policy options. In the case of price policy changes, this could affect, for example,

consumers and producers differently. In the case of fiscal policy reforms involving, for example, changes in revenues and expenditures, these could lead to losses or gains to governments, taxpayers, and beneficiaries of services.

Understanding distribution effects on consumers, producers, and governments, all of whom are potential gainers or losers, can help in:

- handling policy conflict and trade-offs between efficiency and distribution;
- designing and implementing reforms to mitigate or offset any possible negative effects on particular groups; and
- raising understanding among stakeholders—both gainers and especially losers—in the event of a redistribution of resources and income.

Public debate about the distribution impacts of policy change often focuses on the short-term or direct effects of reforms on individuals and households, as well as on businesses and resource owners (Productivity Commission 2001, p. 23). The indirect effects are often less evident, despite their importance in improving the aggregate future situation and the tendency for losers to also become gainers as adjustments occur. This point is stressed with policy changes because, unlike projects (except for those that are extremely large relative to the size of the economy), the effects of policy changes can be economy- and sector-wide.

The impact of adjustments resulting from reforms has been of concern for

well over a decade, especially in terms of the unintended effects on the poor (a framework for which was elaborated on in Chapter 5). As described, where reforms clearly have negative effects on certain groups, mitigation or compensation for losers may be needed. This can be approached by, for example, taxing winners to compensate losers through public funds and resources. However, constraints on related increased short-term taxation may require budget outlays beyond the capacity of existing fiscal resources and necessitate the mobilization of real resources to effect compensation, thus incurring an economic cost of adjustment. Consequently, program loan financing can help meet financing requirements if it is shown to be feasible. Alternatively, mitigation may be considered as a separate operation.

3. Political Economy Considerations

The discussion above shows how the intertemporal and distribution effects highlight political economy considerations of policy change. Clearly, reallocation of resources, redistribution of income, price changes, changes in access to and the cost of services, and changes in transfers all affect the status quo. In turn, this may generate resistance to reform measures among vested interests.

In principle, governments can resolve choices between conflicting policy objectives by weighing priorities accorded to each one of them. However, in practice, governments may be less than precise or consistent in their

objectives. This may leave the resolution of trade-offs problematic. Critically, influential vested interests can be key obstacles to any kind of trade-off process.

As discussed in Chapter 3.F, Sadoulet and de Janvry (1995) emphasize the distinction between political feasibility on the one hand and efficiency and welfare on the other, stressing the point that any policy reform should first satisfy the constraints of political feasibility. It then becomes important, in advance of the passage of the reforms, to identify and understand who constitutes the various groups affected by and opposed to the reforms. The need, magnitude, and practical considerations for possible mitigation or compensation require careful assessment.

For example, while a relatively discrete group such as retrenched SOE workers could be provided for in terms of temporary loss of earnings and retraining, it is virtually impossible to compensate all poor urban households who may be negatively affected by devaluation. Additional measures are only likely to be appropriate where the social safety net and other generally available measures are ineffective or do not fully address relevant impediments. The range of possible additional measures includes direct compensation, and other specific adjustment assistance such as reskilling, workforce programs, and targeted social science assistance programs (Productivity Commission 2001).

It is also generally easier to identify short-run costs than long-term benefits. But even in the short run, some costs are uncertain and, in part, will be a function of the timing and sequencing of the policy reforms, and of the internal and external economic and financial resources made available as part of the reform program. Likewise, economic benefits cannot be guaranteed. Political economy factors and unforeseen exogenous shocks may throw policy reforms off course. Program outcomes may be very different from those anticipated. The size of more certain short-run costs, compared with uncertain medium- and long-term benefits, may also make stakeholders unwilling to embrace the reform program. However, this uncertainty should not be viewed as a constraint in assessing program costs, benefits, and outcomes.

The outcomes of reforms will be further influenced by the structural characteristics of the economy concerned, especially with respect to the existing distribution of productive assets and the severity of the macroeconomic situation which, among other factors, led to the adoption of the reform package in the first place. If economy-wide stabilization and structural adjustment programs are still being implemented or have in some sense failed, at the same time as sector reforms are being implemented, the absorption costs of the stabilization and structural adjustment reforms will represent additions to the costs imposed by sector reforms. Furthermore, as economy- or sector-wide policy changes do not usually occur in isolation, it may be

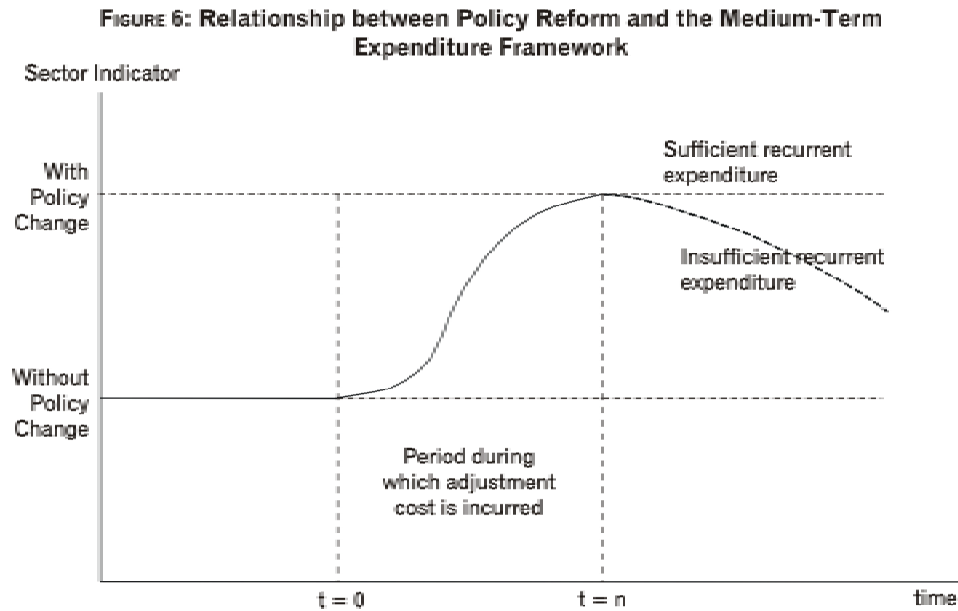
difficult to identify, in advance, the response from other influences (Productivity Commission 2001). Kasper (1999)²⁴ notes the problems associated with ex-ante attribution of adjustment costs to specific policy measures. These constraints support the use of a fiscal framework analysis.

C. Fiscal Environment for Policy Reforms

Policy changes affecting public institutions, spending, and revenue require assessment of their fiscal impact. Figure 6 provides a stylized representation of an institutional reform, such as civil service reform. To achieve the anticipated improved performance, a period of adjustment is required, which will incur costs. Importantly, unless the reformed institution receives sufficient recurrent spending to consolidate and sustain the changes, performance is likely to decline even in its reformed state. As such, adjustment costs may be seen as an investment in a new policy “asset,” followed by the need for appropriate recurrent spending to maintain the new policy asset. The key difference between recurrent cost implications arising from reforms, compared with a project, is that the former can often be sector-wide.

Viewing policy reform as the creation of an asset requiring maintenance spending implies that understanding is needed of the net fiscal impact of reforms in relation to the overall fiscal

²⁴ P. 145, as cited in Productivity Commission 2001, p. 16.



situation. This can be done through assessment of a country's present medium-term fiscal framework (MTFF). The MTFF provides the basis for assessing whether government has the necessary fiscal space to carry out both its overall reform program and specific reform measures. The following questions, especially for reforms with fiscal implications, can be asked in relation to the MTFF:

- What is the existing net fiscal situation, including both revenues and expenditures?
- Will new sources of revenue be generated, how much and when?
- Will increases in recurrent costs arising from reforms be passed on to service users and has their willingness to pay been assessed?
- Does the policy reform add to public expenditure and, if so, in what ways?

- Will the reforms facilitate the realization of budget savings and when do they appear?
- What are the real financial costs over time of effecting the policy change, including consolidation or recurrent costs?
- What is the difference between the financial costs of reform and the government's net fiscal position? This provides an indication of the gap in financial resources needed to implement and sustain the reform.

The MTFF should cover the “without reform” stage, through the “with reform” adjustment process, up to the consolidation stage.

Gradual budget realignment in response to institutional change and capacity building is addressed in a number of

ADB program loans, such as the FSM Private Sector Development Program. In addition to the adjustment costs or “asset creation” stage, the steps used to assess the recurrent budget implications of reform-driven institutional changes related to realigning and strengthening services include:

- assessment of the “without program” resources on an agency-by-agency basis and of overall government;
- assessment of the resources needed with program staff and nonstaff budget requirements for reformed and strengthened agencies;
- identification of the capacity to meet incremental recurrent costs by local and national governments and agencies;
- assessment of executive and legislative branch support for realigned budgets;
- assessment of budget cycles and the period needed to hire, train, and introduce the delivery of realigned services; and
- preparation of a multiyear budget and analysis of possible external support needs during the transition.

The assessment of the fiscal impact of the policy reform complements the economic assessment in the same way that the financial and economic evaluations of a project complement each other. The financial analysis provides pertinent information on fiscal impact and affordability by the government in a fiscal context. The financial assessment of the adjustment process and of the recurrent spending needed to sustain the policy reform

provides valuable insights into aspects such as efficiency gains and distribution.²⁵

Assessing the dimensions of a reform process can assist policy analysts in understanding how the reform will work and in identifying the nature of costs and benefits. Understanding the intertemporal dimensions provides an idea of the timing of the costs and benefits. Assessment of the distribution aspects is necessary to identify the gainers and losers, possible costs involved in facilitating a realignment of resources, and how to manage levels of public expenditure. Attempting to “soften” transitional impacts can involve both real financial and economic resource costs. Where there are political economy implications from reforms, the costs of managing and sustaining reforms need to be weighed. While precise quantification and valuation of the economic costs and benefits of a reform process may be difficult, an understanding of the nature of costs and benefits, and how, when, and on whom they will impact, will help analysts and policy makers develop a judgment as to whether the reform is feasible.

²⁵ Appendix 4 provides an inventory of how the identifiable cost aspects of reforms were assessed in recent ADB program loan reports.