

OVERVIEW

Introduction

Policy-based lending to support policy reform is a necessary development instrument. Support for sector policy reform is the main focus of policy-based operations of the Asian Development Bank (ADB), addressing economy- or sector-wide causes of structural constraints and under-performance.

Two key characteristics of policy change arise. First, policy changes alter the underlying framework influencing stakeholders' behavior. Their response to changes must be taken into account in policy analysis. Second, removal of a policy-related constraint gives rise to another limitation that becomes the next "binding constraint." In this sense, policy reform is a process of removing sequential binding constraints.

The features of policy reform need comprehensive analysis. Policy change is also a dynamic process, and to be effective built-in flexibility in design and implementation is needed involving stakeholders. The evolving nature of reforms requires that ex-ante analysis be supplemented with monitoring and evaluation of the policy change process.

The Macroeconomic Context of Sector Policy

Policy analysts need to understand the macroeconomic context for policy-based operations to ensure the consistency of sector policy changes within the

macroeconomic policy framework. A macro-meso-micro perspective can help in comprehending the forward and feedback effects of sector policy changes.

An appreciation of the macroeconomic context and the mesoeconomic channels through which sector policy changes are carried out helps identify key influences on sector policy. The macroeconomic context, such as growth, inflation, unemployment, and the balance of payments, and key macroeconomic variables, such as interest rates, money supply, and foreign exchange rates can greatly influence the outcome of sector policy reforms. For example, vulnerability to external change and crises can trigger system-wide policy changes and affect the outcomes of structural and sector reforms. Similarly, sector reforms can have feedback effects on the macroeconomy.

Although macroeconomic assessment is country specific, a consistent approach to assessment is needed to understand:

- economic growth performance;
- macroeconomic policy and management;
- key structural policies;
- economic outlook; and
- macroeconomic framework including risks or vulnerabilities.

Policy analysts need to carry out a country-specific assessment and analyze how macroeconomic influences, working through markets and institutions at the economy's mesoeconomic level, affect decisions and incentives by consumers and producers at the microeconomic level.

Dimensions of Sector Policy Analysis

Sector analysis underpins ADB’s policy operations and is needed to understand policy, institutions, and investment issues that affect sector performance. Sector analysis helps to assess:

- sector role and features;
- markets, prices, and the incentives structure;
- government strategy and policies, reform agenda
- key public institutions, performance, problems and underlying causes;
- market and institutional performance, problems and underlying causes;
- solutions, reform and investment needs;
- the rationale for public sector and ADB involvement, and alternative approaches;
- timing and sequencing of reforms and development activity; and
- political economy considerations.

Analysis of market structure, conduct and performance including price policy issues are important, given their impact on economic and financial incentives and on the behavior of affected stakeholders, public finances, and trade.

Institutions include public service providers, market institutions, and the “rules of the game.” Analysis of such issues will help to identify constraints facing consumers and users, producers and providers, how they affect incentives and response, and opportunities for improvement.

Analysis of institutional structure, conduct and performance provides insights into

factors that affect policy implementation and impact. This includes understanding the implementation capacity of public and private institutions to effect policy reform. Reforms involving institutional capacity building usually require a medium- to long-term view, and the time and resource requirements should be factored into the analysis.

The political economy context affects policy formulation, timing, reform acceptance, and implementation. Full awareness is needed of the political environment, a country’s policy priorities, trade-offs involved, and the stance of affected stakeholders. This includes identifying the views of those who will gain from the reforms, and of the vested interests who will lose from reforms and who prefer to maintain the status quo.

Assessing the Effects of Policy Change

Policy change can be analyzed ex ante in different ways with various levels of rigor. Analysis may be limited by practical considerations such as data availability, cost of collection, and human resource capacity.

Key considerations and analytical options are as follows:

- The starting point is to understand the “without program” situation. Sector studies can provide much of the framework and data, and can potentially employ a range of macro, meso, and micro analyses, depending on the type of policy changes and strength of likely feedback effects.
- Advanced assessments of policy options and the effects of the “with program”

situation based on deductive reasoning may be checked by empirical verification. Where data are limited and collection impractical, valid and verifiable assumptions need to be clearly presented to allow monitoring and evaluation during implementation.

- Policy analyses and simulations, where practical, can identify short- and medium-term effects of policy change. General equilibrium analysis is useful if there are significant feedback effects that need to be identified and assessed. Partial equilibrium analysis is useful where feedback effects are low. When equilibrium analysis is not possible, descriptive statistics and provisional calculations should be used to understand sector parameters and possible responses.

Assessing the Poverty Impact of Policy Change

An analytical framework used by ADB for the poverty impact of policy change, the poverty impact assessment matrix, identifies the main channels of effect through which the poor are affected, assesses if the impact is direct or indirect, and outlines the distribution implications between poor and other affected groups. The poverty impact assessment framework is best used as a design tool as part of analytical work.

Assessing the Processes and Costs of Policy Change

Understanding is needed on the processes of cost and benefit realization of policy change as a complement to quantitative analysis of its effects. This will help establish whether reforms are feasible from

the stakeholders' viewpoint, including how they will be affected, whether they can adjust to change, and how they will adjust.

Assessing the policy change process involves four key dimensions of adjustment:

- **Time:** Policy change involves restructuring that often occurs over the medium to longer term. Policy change effects need to be considered in dynamic, not static, terms.
- **Distribution:** The distribution effects of reforms need systematic assessment to identify who the gainers and losers will be as the adjustment process unfolds.
- **Political economy:** Given the time and distribution effects, the groups affected can be identified and their views canvassed on reform support—or opposition and why. The strength of vested interests compared with that of reformers should be assessed. The need for possible compensation for groups negatively affected during the adjustment process can be assessed and built into the program's design and costs.
- **Development implications:** Often, reform measures will have direct linkages to development efforts, such as institutional reforms and related capacity-building needs, and complementary investments. The link between reforms and complementary development efforts should be established to increase the likelihood of sustaining the reform effort.

The government will have to shoulder any fiscal impact of reforms. Reforms should be considered in the context of the prevailing fiscal situation and their impact

on the future framework through analysis of national or local medium-term fiscal frameworks.

Incorporating Policy Change Assessments into Program Design

The final, essential step for policy analysts involves incorporating the results of analysis into program design.

The analysis helps inform decision makers and affected stakeholders of options and their possible outcomes. A basic requirement of successful reform implementation is that these groups reach a shared understanding of the nature, costs, and dimensions of policy changes. Summary matrixes used in ADB loan documents help highlight key analytical and design points.

The policy matrix, foreexample, can be considered as a road map for government commitment on specific policy actions to ensure that the reform implementation is on the right track. The emphasis of the policy measures in the matrix should be on milestones and key actions. Clear linkages between the poverty impact assessment framework, program logical framework, and policy matrix help ensure consistency between the analysis and design.

Monitoring and evaluation during and after reform implementation should supplement practical policy analysis as part of program design. This will also help in overcoming the inherent risks and uncertainties of up-front analysis and in putting policy reforms into effect.