Governance, Leadership, and Communication

Venezuela
Malaysia
Tanzania
Bolivia
Egypt
Ghana
Pakistan
Turkey
Brazil

Edited by Leila Frischtak & Izak Atiyas

The World Bank • Private Sector Development Department
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A large number of countries have initiated market-oriented reform programs in the last few years. Progress has been generally impressive, and much headway has been made in various forms of liberalization. Many countries, however, still face substantial difficulties in creating an enabling environment for private-sector-led growth and reorienting public policy to achieve and sustain macroeconomic stability, attend to needs of physical infrastructure development, invest in human resources, create an adequate social safety net for the poor, and address environmental problems. In this context, many countries are struggling with the difficult task of transforming the role of the state from one of a producer and major allocator of resources to one of an efficient regulator of competitive markets. Policymakers are clear on the general objectives, but confront the difficult problem of how to achieve these objectives. This volume provides important insights on both the nature of these difficulties and what can be done to overcome them.

Market-oriented reforms, and the institutional changes they entail, amount to nothing less than establishing a new social contract between the state and its citizens. This contract is viable only if there is consensus. Creating this consensus, and the constituencies that support it, is one of the most important challenges facing countries that seek to institute economic reforms.

The studies in this volume provide three lessons that are particularly important. The first confirms the validity of a change that is already taking place in the thinking of the development community. While economic reform programs have been preoccupied with reducing the excessive dominance of the state in the economy, until recently less attention had been paid to the need of well-functioning markets for capable state involvement. Accelerated private sector development and growth require that the state actively generate confidence and a belief in state credibility among the citizens.

The second lesson is that enhancing state capabilities requires more than reshuffling or restructuring government agencies. What counts is not only incentives, but also change in culture. Institutional reform is only going to be successful if it is accompanied by a change in the established beliefs, expectations, and perceptions, not only among the agents of the state, but also in the citizenry. The third lesson relates to the role of communication. The benefits of reform are neither immediate nor self-evident. Much progress can be made in instituting economic reforms if the benefits are explained effectively to the various...
ship under closer empirical scrutiny by trying to examine how its dynamics actually played out in several different reform experiences. There was no intention to engage in any theoretical exploration of the problem of the state, or of governance in general; on the contrary, we were firmly grounded in the context of concrete episodes of attempted economic reforms, be they accomplished, ongoing, or reversed. Nevertheless, we had the keen hope of further elucidating the significance of the governance problem during the last fifteen years as it intersected both the path of adjustment and the crisis that preceded it. Indeed, we believed from the start that governance mattered for reform in more ways than have thus far been credited.

Governance is not a concept of academic origin; it made a rather informal, back-door entrance into policy analyses of economic reform processes as it became increasingly clear that the most serious obstacles on the path of reform were of a noneconomic nature. Among these, social and political sensitivities, internal opposition, and lack of consensus for the policy changes were already recognized in the World Bank’s first review of structural adjustment lending. But apart from the issue of compensating the groups most affected by reform, the greatest attention was given to the problems of the administrative capacity of governments and their degree of commitment and “ownership” of the reform program (these last two terms were often used interchangeably) (World Bank 1988). By the time the Bank’s third review of adjustment lending was published, the idea of “ownership” seemed to encompass many requirements of successful economic reform, such as the government’s commitment to the program and its ability to foresee distributional consequences of reforms, identify potential resistance, and overcome it (World Bank 1992a). Meanwhile, numerous reports and documents calling attention to the role of governance issues were produced, and governance eventually became the selected general concept to capture and define the interest of both the World Bank and other international institutions in the political and institutional factors affecting structural adjustment.2

Governance has been portrayed by policy analysts primarily as a source of constraints to successful economic reform, and as more such political and institutional constraints were identified, the coverage of policy advice—and conditionality—also expanded.3 Operationally, governance shortages were most often located in the administrative capacity of states; the problem of governance could be straightforwardly equated with the quality of the governmental bureaucracy, or alternatively, with the organizational structure of governments. Policy prescriptions to improve governance have typically focused on the matters of civil service reform and the redesign of the size and attributes of the government and its branches. More recently, the traditional emphasis on the rolling back of the state and its regulatory functions has diversified into calls for the strengthening of crucial legal instruments and the implementation capacity of governmental agencies—for instance, by clearer property rights and contract enforcement mechanisms, judicial reform, and personnel retraining programs. Greater transparency and accountability in institutional arrangements and governmental decisionmaking have also become standard governance-related prescriptions, in line with reform’s goal of generating an enabling environment for the successful operation of markets.

The growing interest in governance in the multilateral financial institutions spearheaded

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3 This expansion was not unrestrained; within the international financial institutions there was also serious concern about growing involvement with political matters that properly pertained to the competence and authority of sovereign countries. See the work of Ibrahim Shihata (1990) for the definition of the boundaries of the legal mandate of the World Bank in governance issues.
the inclusion of ever-more detailed state reforms in the structural adjustment package, but did not lead to any systematic evaluation of the actual impact of governance issues, or its underlying causes, on reform experiences. More specifically, the very important recognition that economic policy reforms required new institutional arrangements in governments was not followed by attempts to explain why these institutional changes proved so difficult to realize in concrete reform experiences. Rather, the accomplishment of these changes has either been taken for granted or implicitly subsumed to governmental commitment and "ownership" of the program. Nevertheless, in the accumulated experience of structural adjustment so far, state reforms appear as the most intractable task; even in countries where reform programs have gone forward for long periods and have performed well on many economic grounds, attempts to introduce reforms in the state and its operational arrangements have generally been ducked or aborted, resulting in distortions or unstable measures of compromise in the conduct of policies. Thus, the "voluntaristic" approach to institutional change seems unwarranted, and exposes the lack of a more serious and informed reflection on the very nature of social and political institutions.

The political and institutional aspects of economic reforms were not, of course, the exclusive concern of the policy analysts directly engaged in their design and promotion. The challenges and the faltering course of adjustment in developing countries were also the subject of a more research-oriented political economy literature. Although lacking explicit references to governance, this literature addressed issues similar to those discussed in this volume.

One strand of this literature, more empirical in orientation, is represented by a series of comparative studies on reform experiences that focus on the same general question: why do some countries respond more quickly and effectively to crisis than others? These studies attempted to identify patterns relating major features of societies, their economies, and their political regimes to different policy choices concerning economic reform or, alternatively, to the likelihood that reform could succeed. Policy choices could vary in the timing, speed, scope, and content of the measures—that is, how early reform was adopted, how fast trade liberalization or privatization programs were implemented, whether comprehensive structural reforms or only stabilization reforms were favored, and how "orthodox" the reform program was. In at least a few of these studies, the underlying premise was that the set of institutional and political constraints that characterized the policy environment had a large role in shaping economic policy choices. More recent comparative studies have focused on the interaction between the economic and political processes of change, the so-called dual transition to democracy and markets.5

Of most direct concern here are the pertinent and insightful ways in which the political dilemma of economic reform was characterized in this literature. The central problem of reform is aptly described in terms of the distributive issues involved and the difficulties in managing intertemporal tradeoffs: although reform policies can be expected to be welfare-enhancing in the long run, substantial conflict surrounds the distribution of costs and the displacement of rents in the short run; that is, reform entails "significant start-up costs" (Haggard and Kauffman 1992, p. 18). Reform is not only politically divisive and conflictual, but also technically and ideologically controversial. At least initially, the costs of adjusting out of what was essentially a global crisis were disproportionately imposed on developing countries. Although the ultimate goals of reform gained increasing consensus, acute disagreement

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remains over the pace and extent of the measures to be implemented, the acceptable limits of their costs to vulnerable social sectors, and the relative roles of markets and states in resource allocation (Nelson 1990, pp. 4, 5). In addition, there are structural antinomies between the reform requirements—such as fiscal retrenchment and monetary austerity—and the logic of the behavior of politicians, whose likelihood of remaining in power is often contingent on their access to public resources to allocate spending, distribute political benefits, and generate supportive constituencies (Bates and Krueger 1993, p. 463).

The comparative literature on economic reform has produced a number of generalizable observations on the impact of political constraints in economic reform processes. As a general rule, the issue of state capacity in this literature is associated with the government bureaucracy, and more particularly with its capacity to implement policies. State capacity is but one among many institutional constraints shaping the policy process, and a passive constraint at that. Nevertheless, correlations can help define probabilities, but do not constitute explanations; neither policy choices nor their implementation can be entirely explained by (or automatically deduced from) the identification of constraints and incentives faced by policymakers. The comparative studies on economic reform mapped out a rich repertoire of constraints in the policy environment and revealed the many complex ways in which these constraints could be related to a variety of economic policy choices. On the whole, however, they were less forthcoming in the suggestion of causal or behavioral arguments on the dynamics of the reform process. This can at least partially be attributed to a certain understandable reluctance to ascribe more than a residual role to the unpredictable qualities of leadership. Nevertheless, as Grindle and Thomas correctly point out, active and skillful policymakers can modify environmental constraints, reshaping the "policy space" and enlarging their room for maneuver and change; indeed, the fate of economic reform may largely rest on leadership and its scope for action (Grindle and Thomas 1991, pp. 182–88).

Another strand of more formal and theoretical political economy literature has identified a set of generic collective action problems associated with the underlying distributive issues of economic reform. These problems are supposed to explain why societies may persistently fail to adopt policies that are welfare-enhancing and clearly superior to the policies in place; more specifically they are supposed to explain why stabilization and trade liberalization reforms may be inordinately delayed and postponed. The first of these problems is uncertainty. The literature has characterized this problem in various ways: as uncertainty over whether or not the policies will succeed, and therefore over the magnitude of the rewards, and doubt about the distribution of the resulting costs and benefits.

A second problem is associated with difficulties of coordination among different groups—or more specifically, the inability of groups to reach agreement over distributional conflicts. This inability may be the result of asymmetric information among the groups, or of the absence of mechanisms whereby groups can commit themselves to more cooperative courses of action.

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6 Bates and Krueger call attention to precisely this point in the excellent concluding chapter of their volume (Bates and Krueger 1993).

7 Good reviews of this literature can be found in Alesina 1994; Alesina and Perotti 1995; Asilis and Miseli-Ferreti 1994; and Rodrik 1993, 1994. Paul Seabright has more particularly focused on how to integrate the problems identified by this literature with the governance concerns of this volume (Seabright 1994).

8 Fernandez and Rodrik (1991) have argued that uncertainty may lead the majority of the population to vote against policies that ex post clearly benefit this majority; Laban and Sturzenegger (1994) also show how reforms are delayed because of risks associated with the uncertainty of compensation.
Distributional conflicts have been modeled as a war of attrition between social groups over which one should bear the costs of adjustment, resulting in stabilization delays, which are costly to all parties.\(^9\) They have also been analyzed as predatory behavior, whereby social groups demand (and may obtain) subsidies from the state, even though the only way to finance these subsidies is through inflation, which will represent a costly tax to society.\(^10\)

In the characterization of these problems there is the conspicuous absence of any reference to the role of governments. Indeed, in the modeling of these distributive conflicts either the state is assumed away—its actions presumably the automatic translation of the expressed preferences of social groups, whatever the interest aggregation and representation mechanisms in place—or policymakers are “assumed in” the conflicts like any other social group, with similar behavioral incentives.

Nevertheless, in the identification of yet another crucial problem affecting the feasibility and the course of reform, that of credibility, the same literature brings the state—or policymakers—back in. Reform policy announcements are not credible if policymakers are not perceived to have the ability, the commitment, or the incentives to carry them out. Lack of government credibility prevents social groups from responding positively to reform policies, leading to the ineffectiveness of these policies. Credibility problems may also arise in the inconsistency of the policy package, but credibility is increasingly being associated with perceptions of whether policymakers can overcome political constraints and generate the necessary support for the policies announced.\(^11\)

While this literature does not make reference to governance issues, the problems it discusses are important elements of the governance concerns of this volume. Stalemates that result from lack of coordination and cooperative behavior can—and should—be overcome by government provision of commitment mechanisms. Similarly, uncertainty over the distribution of gains and losses associated with reform policies can be significantly reduced if the government can credibly convince potential losers of ex-post compensation. Indeed, the very persistence of these distributive conflicts in delaying reform can be seen as evidence of low governance capacity.

One final entry point to our governance concerns is provided by this literature’s questionable assumptions that social groups or individuals necessarily have direct, clear perceptions of their pecuniary interests, and that their support—or lack thereof—of reform policies is oriented by a calculus of probable gains and losses that is unaffected by politics and values.\(^12\) As will be argued below, even self-interested individual behavior is shaped by mental constructs that are based on culture and experience. As Bates and Krueger have suggested, given conditions of uncertainty such as those a comprehensive economic reform program produces, there may be considerable latitude for political persuasion (1993, p. 456):

Under conditions of uncertainty, people’s beliefs of where their interests lie can be created and organized by political activists; rather than shaping events, notions of self-interest are shaped and formed. In pursuing their economic interests, people often act in response to ideology.

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9 See Alesina and Drazen 1991; and Drazen and Grilli 1993. Because the losses are private information, rather than conceding to bear the cost, each group prefers to wait in the hope that the other will concede first.

10 See Mondino, Sturzenegger, and Tomassi 1993.

11 The perennial problem of the relative merits of “gradualist” versus “big bang” reform approaches has recently been recast in terms of the government’s credibility to overcome political resistance and constraints (see Dewatripoint and Rolland 1992).

12 See Herbert Simon for a discussion on the distinction between the “the real world and the actors’ perceptions and reasoning about it” (1986, p. 27). The impact of norms, values, and culture on individual behavior recently has been the subject of an expanding literature. See, for instance, North 1991 (especially chapter 2); Koford and Miller 1991; Sugden 1989; and Kreps 1990.
An Analytical Roadmap to Governance Capacity

While recognizing that a number of other variables affect the course and outcomes of economic reform, the comparative studies in this volume have placed their central focus on governance issues. Our guiding research premise was that the problem of governance can be seen not only as an exogenous constraining factor, but also as a pivotal constitutive part of the transition to a development strategy that had as its main target the substantial reduction of state intervention in the economy. This transition surely required from the government bureaucracy a new set of skills to exercise new functions, the restructuring of agencies and instruments associated to former policies, and a new bureaucratic ethos, quite different from that prevailing in prereform economic regimes. Yet the regime of regulatory controls, the extended presence of the state in society, and the economic policies previously practiced by most developing countries were also intrinsically connected with the forms of government management of distributional and other conflicts, and with the power basis from which these governments derived their capacity. Hence, surgical interventions to change policies and their supporting institutional arrangements are unlikely to work, because neither is easily delinked from politics, patterns of political management, and the larger institutional fabric of societies.

Indeed, the economic crisis that led to the need for structural adjustment was also, either latently or actively, a crisis of governance that heralded the exhaustion of old patterns of state management of both conflict and cooperation. The more prolonged and acute the crisis, the more ineffective the system of controls became, and the more steadily the resulting rents decreased, eroding the power sources of governments and their ability to conduct consistent policies, let alone to change the direction of those policies. Major fiscal failures were common symptoms of governance failures. Therefore, the process of structural adjustment is as much about economic change as about a regrouping of state capacity around new parameters, reinventing governance on a new institutional and political basis.

Governance matters for the purposes of economic adjustment not only as administrative and bureaucratic capacity, but also as the ability to exercise control over the instruments of economic policy and over the policy process, inhibiting the ad hoc, extensive, or predatory access of private interests to state resources. States that have been substantially penetrated by powerful interest groups are seldom able to promote major shifts in the overall direction of policies, especially if this shift entails significant income displacements. Governance also matters for reform as the political and strategic capacity of governments to organize the means of cooperation and manage the distributive conflicts of reform, reducing uncertainty, compensating or neutralizing losers, and building support coalitions among potential gainers. Most important, insofar as adjustment involves both policy and institutional change, reform-oriented governments are further taxed in their capacity to build large and actively engaged social constituencies for longer, more complex, and conflictual processes of institution-building and adaptation, the ultimate outcomes of which cannot be fully anticipated.

In spite of all the renewed academic interest in institutions, little is known about the processes that can intentionally bring about institutional change. A proper discussion of institutional

change could not even be outlined within the limits of this introduction, but the resilience of institutions was surely underestimated by those who set the agenda of economic reform, because “new institutions are not likely to spring from the ground, in ready-to-wear fashion, as a result of expert design alone” (Frischtak 1995, p. 13). Institutions are the established rules, shared values, and accepted goals that regulate collective behavior. They are deeply embedded in culture, and inescapably intertwined with the ways culture “reads” past experience and frames expectations for the future. Institutionizing the comprehensive changes of economic reform thus means, at the very least, weaving these changes into the existing institutional stock by casting what is new in terms compatible with the old, and by bending and remolding the inherited legacy. In sum, it means creating a new language of norms, values, and goals to regulate, give meaning, and motivate new patterns of social and economic behavior.14

The main point argued here is that it is highly questionable that institutional changes can be unilaterally and deliberately accomplished in accordance with blueprints, enlightened as these may be. Considerable societal input will be necessary for the blending and reshaping that can render new institutions effective. This may particularly be the case in the matter of state reforms. The general orientation of adjustment often runs against society’s ingrained expectations of state performance and behavior. Indeed, they may disrupt the nature of the contractual obligations—symbolic and material—between state and society. Behind the decade-long trend of either half-heartedly promoting adjustment measures or avoiding them altogether were the difficulties faced by a debilitated state, not only in breaking the hold that powerful clienteles of interests had on the policy process, but also in departing from the institutionalized codes that established the basic economic and social responsibilities of the state. From the very emphasis on competition to the removal of compensatory subsidies, many of the new policies can appear incongruent with central tenets of the inherited political culture.

Institutional absorption and society’s ownership of the reforms, complex as they already may be, do not stand a fair chance unless the nature of the policies can be made clear and accessible. The current agenda of economic reform is seldom the object of popular demand, and the movement to promote reform rarely originates in society. Prolonged and acute economic crisis and serious misperformance of governments may have prompted widespread demands for economic and political change, and even a certain degree of prior adjustment in the economy. The timely emergence of leaders committed to reverse economic crisis helped tilt the balance in favor of even quite stern stabilization measures almost everywhere in the developing world. Nevertheless, it is unlikely that the initial support obtained by this leadership was based on the full understanding of the complete menu of reforms that adjustment implies. More specifically, it is unlikely that this initial support translated automatically into a social mandate for full-fledged economic reform.15

Thus, governments committed to lead adjustment processes from the top down have to face

14 North, for instance, has argued: “we are still a long way from having neat models of cultural evolution . . . but we know that cultural traits have tenacious survival ability and that most cultural changes are incremental . . . Equally important is the fact that the informal constraints that are culturally derived will not change immediately in reaction to changes in the formal rules” (North 1990, pp. 44–45).

15 See Frischtak 1995 for the argument that while governments may have an intrinsic mandate to guarantee the conditions of macroeconomic stability, this is not the case for the so-called structural reforms and the institutional changes that these reforms necessarily imply.
up to the task of engaging extensive support for far-reaching economic and social changes when society is probably barely aware of the meaning, implications, and overall purpose of these changes, and is likely to resist them and continue to disagree over the distribution of their costs. The pivotal role of political communication comes into play here, with its potential to render reform intelligible; to change perceptions; and to reshape expectations about the economy, the state, and the social order in general. Yet in the context of weakened governmental capacity, where the state is itself the object of necessary institutional changes, the success of economic and political adjustment may largely depend on the less tangible and predictable element of credible and politically able leadership, and on this leadership’s ability to produce convincing political communication, rendering the goals and the benefits of reform clear and desirable.

Our research project attached great emphasis to the role of effective political communication in generating social constituencies for economic reform. Our main suggested hypothesis related to the possible impact of visions, or broad and clearly articulated projects of economic change, in enhancing the chances of reform efforts to endure, and ultimately succeed. As originally stated, effective visions of adjustment “should project both change and the idea of a future, pertaining to society in a comprehensive way, and [relating] the economic changes proposed, in an intelligible . . . form, to other domains of social life.” In addition, the concept of such visions should “correctly diagnose the messages that can be made [culturally] acceptable, representing the benefits and the values of adjustment in terms compatible with the general expectations of society” (Frischtak 1993, p. 7).

That the economic changes involved in structural adjustment cannot be dissociated from the broader institutional and symbolic fabric of societies brings us to a final point on the relevance of governance. Although our concern with governance may be bounded by its role in economic reform, it is necessary to keep in mind that for the societies in question, governance is a much larger issue than reform. Governments whose policies appear illegitimate in general, or unresponsive to crucial societal demands even in areas not directly connected to the reform policies, or otherwise enjoy reputations for corruption, are unlikely to sustain the course of adjustment in the long run. Governance failures in convincingly presenting public policies in terms of the public interest will sooner or later alienate most social groups from the reform process.

The ideas outlined in this section describe the concerns that led us to this comparative investigation and delineate the main elements of our project’s exploratory argument on the role of governance in economic reform processes. The project’s original working document suggested hypotheses, defined the main variables, and proposed a series of research questions to guide the focus of inquiry of the country case studies examined. Nevertheless, this document also stated our firm intention that the authors should be given considerable latitude in their research to find out what sort of governance issues actually affected reform attempts, and in what manner. We avoided constraining definitions of governance that could distort what we wanted to find out, preferring instead to let the case studies tell their governance and economic reform stories. The next section presents a summary of these stories, and highlights the most salient themes and issues they reveal.
Country Studies and the Main Themes

The chapters included in this volume tell quite distinct stories about how economic reform processes evolved in each country context, about the nature of the obstacles encountered, and about the varied ways in which governments tried to overcome them. In particular, the case studies portray how a range of governance issues came into play in very singular ways in the reform experiences.16

The Story Lines of the Case Studies

Venezuela

As a major oil exporter, Venezuela was strategically situated to benefit from the two oil shocks of the 1970s that generated serious macroeconomic imbalances and initiated a general cycle of stagnation in the rest of Latin America. Nevertheless, the 1980s were also a lost decade in Venezuela, with declining growth rates and macroeconomic instability. Primarily because of gross economic mismanagement, by the end of the decade the public debt had reached alarming figures, and the country was narrowly skirting hyperinflation. The author argues that in the process, growing inefficiency, extensive rent-seeking, and widespread perceptions of corruption greatly impaired the state’s governance capacity. The Carlos Andres Perez (CAP) administration came to power in 1989, and launched a comprehensive reform program, which from the start targeted not only stabilization, but also carefully conceived structural changes. The response of most economic indicators was very positive, and progress was even faster than expected almost across the board. It is true that although significantly reduced, the fiscal deficit was never totally eliminated, and the privatization program moved somewhat more slowly than planned. In addition, growth took at least a year to resume, which may have taken a political toll. Nevertheless, the program was quite successful. There was no shortage of technical capacity or commitment in the design or the implementation of the plan by the leadership and its small bureaucratic team. The credibility of the program abroad and with major domestic economic agents was quite high.

After five years, however, the program was entirely abandoned; its achievements reversed; and, following mounting opposition, urban riots, two attempted coups, and growing political isolation of the executive from Congress and from society at large, the president was impeached on corruption charges, and his economic team was removed from power. Economic reform, unequivocal economic success, was a major political disaster.

The argument of the author relates the reasons for this disaster to both institutional and dynamic deficiencies of governance capacity—that is, to major political and bureaucratic shortages in the structure and mode of operation of a very deteriorated state, as well as failures in strategy and symbolic aspects of the exercise of leadership. Because of the centralized nature of the decisionmaking power, and the short-run institutional autonomy of the executive from Congress, the governance capacity of the state was not considerably taxed in the launching of the program, once leadership and a team with commitment and technical capacity could establish credibility to pursue reform. The success gained in restoring macroeconomic equilibria and discipline was in itself a measure of improved capacity, or could have become so if the government had capital-

16 This section is the result of the collaborative efforts of Leila Frischtak and Izak Atyas.
Governance, Leadership, and Communication: Building Constituencies for Economic Reform

ized on this success politically. This capitalization could have enabled the government to address the reform of the state and the major structural deficiencies of capacity. But neither success in stabilization nor in the series of structural changes achieved resulted in any significant political dividends for the reform-minded government, and thus the opportunity to enhance capacity on the substantial and lasting basis necessary to continue reform was lost.

At the heart of the inability to transform initial economic success into political support, and thus sustain reform, was an overwhelming communication, or vision, failure. Vision did not prove important at the beginning, not even to pursue structural reforms, but it was the crucial obstacle to bridge the governance gap and make these reforms potentially sustainable. Indeed, the CAP government was not elected on a reform platform, nor did it ever have a mandate to promote reform. There was no prevailing awareness of the need for reform and of the inadequacy of the development model in place. The general public perception was that the economic crisis was simply a matter of widespread government corruption and inefficiency, hindering the performance of an otherwise very rich economy.

A radical change in policy orientation without explicit efforts to generate demand for it led to a situation in which even accomplishments and successes carried no meaning, or, most important, political support. The strategy of discounting the importance of an active selling of reform to obtain a mandate to implement change led to society's gradual alienation from the policies pursued, and eventually to active opposition and the emergence of the antireform political entrepreneurs who made use of the communication vacuum. Thus, reform never generated strong constituencies in society, which resented the lack of emphasis on distribution and the closing down of the usual channels of access to resources and rents, nor did it generate any support in the Congress. The sheer constitutional prerogative of the executive to carry reform policies forward independently did not amount to effective power to do so. Thus the government was locked into a process of growing political isolation, even from its own party, its achievements politically mute, and the displacement costs carrying a lot of political water.

Malaysia

Malaysia's economic policy framework in the 1970s and early 1980s was governed by the New Economic Policy (NEP). The NEP entailed a web of redistributive policies and was the political leadership's response to the interethnic conflict that resulted in mass riots in 1970. It represented an end to an arrangement whereby politics was left to the Malays and the economy to the Chinese, and the state was noninterventionist. Identifying poverty and Malay resentment of income and wealth inequalities as the main cause of ethnic discontent, the NEP envisaged the "restructuring" of ownership as an effective means to diminish ethnic imbalances, and sponsored the growth of a Malay business class in the context of a growing economy. It entailed vast outlays of public sector expenditures and public sector ownership, heavy regulation of private business activities and investment, and an array of incentives and subsidies.

The NEP regime was characterized by a high level of governance capacity. The basic framework of interethnic redistribution found general acceptance in the society and provided the boundaries of what was seen as acceptable, or even "realistic," in the public debate on economic policy. This was partly because it filled a "vision gap" in the aftermath of the ethnic problems of the late 1960s. But there were additional factors. A "power-sharing" arrangement consolidated during the Razak administration, which united a broad spectrum of parties into a national front, provided the stable political framework in which NEP was sustained. The bureaucrats and the technocrats were successful in the actual implementation of
the project. NEP also delivered high economic growth, enabling the achievement of the NEP goals without much deprivation for the non-Malays.

By the early 1980s, when Mahathir became the prime minister, the NEP regime was facing several difficulties. Public sector companies, which under NEP were supposed to play an important role in the “restructuring” of ownership, were economically inefficient. The Malay business class nurtured through NEP was uncompetitive, and too dependent on state subsidies. Non-Malay business came to resent state regulation that constrained their business activities. Even among some Malay business circles, NEP’s redistributive policies were increasingly seen to hamper growth. In the meantime, the international recession was taking its toll on the Malaysian economy: the collapse in commodity prices reduced Malaysia’s export earnings, while rapidly rising interest rates increased its debt burden. Mahathir initially tried to implement a countercyclical program that entailed a rapid increase in public expenditures. This proved ineffective, and a delayed but deep recession took place in 1985–86. This time the Mahathir administration responded with fiscal austerity and progressively dismantling the policies that formed the basis of NEP.

The authors provide a vivid description of how the interplay of the economic and political crisis and Mahathir’s search for a response to these problems eventually crystallized his quest for modernization into a vision with very different features from those of NEP. His implementation of adjustment policies following the 1985–86 recession was primarily a pragmatic response to the economic crisis. Adjustment was not presented as an alternative to NEP; on the contrary, any inconsistency of adjustment policies with NEP was downplayed as a temporary “abeyance” of NEP to reverse recession and stimulate growth. In the process, however, many of the redistributive policies of NEP were abolished. The adjustment proved extremely successful, and the economy resumed growth.

Growth, in turn, vindicated Mahathir’s handling of the crisis. This initial success with adjustment was followed with a strong and ultimately successful effort by the leadership to articulate an ex-post vision that provided a new collection of social goals and consolidated the new policy regime, which effectively dismantled NEP, albeit without explicitly renouncing it. The effort was successful, and by the early 1990s NEP’s redistributive discourse, which until then had dominated the public debate, was replaced by a new one emphasizing free enterprise and market forces. The new vision was instrumental not so much in adopting or implementing adjustment policies, but in making the new policy framework redefine and shape the role and scope of state intervention; in particular, ethnic redistribution ceased to be the primary goal of the state.

Tanzania

The policy development framework of Tanzania in the 1960s and 1970s was largely shaped by the principles of self-reliance and egalitarianism, with an emphasis on rural development, as articulated in the Arusha Declaration of 1967. The state was to play a leading role in large-scale activities, whereas rural development was to be achieved through cooperative agriculture. Particularly in the 1970s, however, there was a marked shift toward increased centralization and state control. This was especially evident in agriculture, where centralization of the marketing activities in the Crop Authorities, carried out partly as a means of consolidating the political power of the party, resulted in the steady erosion of agricultural export production and created a heavy burden on the budget.

Riding on financial aid provided by the donor community, Tanzania responded to the first oil shocks by postponing adjustment and expanding government controls over the economy (for example, on imports, foreign exchange, and credit
allocation). The effects of the second economic crisis in 1979 were devastating, in effect generating serious scarcity of even the most basic goods in the market.

The expansion of controls was paralleled with a visible deterioration in governance capacity. The managerial capacity of the state and its system of government and administration deteriorated sharply, not only because of limited initial human capital, but also because of the leadership’s emphasis on the role of the party and the politicization of the decisionmaking process. Also, the increasing scope of state controls overburdened the bureaucracy and further deteriorated its ability to implement the controls. Concentration of political power within the party undermined its ability to carry out the developmental tasks it assumed. As economic difficulties increased, the private sector’s response to increased government controls was simply to move beyond the reach of the state, into the parallel economy. This weakened the tax base, resulting in a further decay of government control. Controlled prices became irrelevant, as did official channels of allocation of foreign exchange, because most transactions were carried out in the black market. Widespread perceptions of corruption further undermined the public’s trust in the government. Despite the deteriorating economic conditions, the leadership did not produce a proper response to the crisis. There was ideological resistance, because liberalization was seen as conflicting with the egalitarian principles of the Arusha Declaration. In addition, there were fundamental interests at stake, because liberalization would entail curtailing the privileges of the parastatal sector.

Reform attempts finally started in 1984 as a response to the deepening crisis, and progress was made, especially in liberalizing the exchange rate and foreign trade and deregulating domestic prices. Progress in parastatal reform has been much slower, mainly because of resistance from the parastatal bureaucracy. The dismantling of state monopolies in the trading of export crops and the introduction of competitive marketing did not take place until 1994, even though reforms would have benefited the large mass of small farmers.

Deficiency in governance remains the weakest link of economic reform in Tanzania. The original reform agenda and donor orientation underestimated the importance of enhancing the capacity of the government to perform its functions. The lessening of state intervention did not in itself repair the capacity needed to carry out the remaining tasks vital to the functioning of a market economy, including management of public infrastructure, the delivery of social services, and the implementation of public investment programs. Indeed, Van Arkadie argues that adjustment policies have probably contributed to the further deterioration of the state by accelerating the shift of income away from the public sector and by establishing fiscal stringency. As a result, the author argues, what is required is nothing less than the reconstruction of the state, including a careful redefinition of the responsibilities of government in the new economic regime.

**Bolivia**

By the early 1980s Bolivia was struggling with hyperinflation, primarily the result of large fiscal deficits accumulated in the late 1970s. Other imbalances were also present, connected with the diminishing performance of the system of “state capitalism” put in place in the 1950s, which ascribed an enormous regulatory and productive role to the state in the economy (the share of the public sector in employment was the highest in Latin America) and posited a political alliance with the state-controlled unions at the expense of the domestic business sector. As the author argues, the system of rents, job patronage, and clientelism in public contracts (on which a large part of the urban middle-classes depended) had degenerated into rampant corruption and predation, and the state capacity to govern was close to exhaustion. Within this context, the partial and gradualist
stabilization attempts of the early 1980s did not succeed.

The incoming 1985 government of Paz- Estenssoro launched a radical and comprehensive stabilization program that directly targeted the fiscal roots of inflation, and included a cash budgeting system and tax reforms. It reaped quick success, and consequently ample public support, in arresting inflation, and with the political capital accumulated it quickly moved on to push structural reforms aimed at trade liberalization, changes in financial and investment regulations, and reduction of the discretionary power of the bureaucracy to distribute rents and patronage.

Despite these early achievements and the consistent commitment of successive administrations, the initial impulse of reform could not be sustained at the same pace. Progress in several other necessary and more complex structural reforms was hindered by increased opposition and what seemed to be a reversal of the previous trend of expanding governance capacity, at least in some crucial aspects. Among the most difficult and controversial stalled reforms were the privatization program and the reorganization of the Social Security system. The author attempts to examine the reasons behind this discontinuity between early success and strong political support, and the subsequent slowdown in the pace of policy changes.

The main explanatory proposition advanced relates to the different dynamics underlying what Morales calls “first-generation reforms,” which include stabilization, deregulation, and liberalization of domestic and foreign trade, and “second-generation reforms,” which are identified as relating to a redefinition of the roles of the government and the private sector, as well as institutional changes to enhance savings and investment. The former will carry support, even if they entail harsh measures and are accomplished in an undemocratic fashion, and especially if there is widespread perception of crisis, which was the case in hyperinflationary Bolivia. Nevertheless, once there is a sense that the crisis is over, no such automatic support is bestowed on reform-minded governments. Second-generation reforms require complex political management or extended governance capacity to generate consensus and convince, in terms compatible with the expectations, that this particular choice of development strategy is desirable for society as a whole. In particular, Morales argues, it may be necessary to develop a vision that attempts to present reforms in a manner compatible with traditional values in the political culture.

The author suggests that the reform governments in Bolivia did not have a complete plan of economic reform from the start. Some structural reforms may have been pursued initially for their announcement value—that is, to generate credibility for the stabilization program and distinguish it from the past, failed attempts. Only later, riding on the success obtained from successful stabilization, did they decide to seize the opportunity to fundamentally alter the development model, a course of action that would bring in the much-needed international approval and resources. Vision was not a part of, and did not seem important for, the early stages of reform.

Nevertheless, sluggish growth and investment, coupled with perceptions of a lack of fairness in the distribution of rewards, complicated the continuity of reform. As Morales remarks, business was widely seen as reaping the main benefits and controlling the political process, with the population carrying the burdens and the losses of reform. Apathy eventually prevailed among the general population, while small and unrepresentative groups gained the ability to effectively block further policy efforts and initiatives. The lack of any efforts of vision-making and message crafting in terms that could be meaningful to the public thus took its toll. Indeed, because the path of structural reforms was shaped “on the go,” they were generally justified on the basis of engineering values of efficiency and rationality at the expense of the ingrained values of solidarity and the expectations of greater equality. In contrast, a com-
pelling vision of reform would have to render its costs acceptable as short-term investments for a better future, and credibly demonstrate that its benefits could be shared on a universal basis.

Governance capacity may also have faltered in the identification of the strategic importance of the great losers of reform, the lower and middle urban classes and organized labor. The Social Emergency Fund, a successful program of compensation, was targeted not at these groups, but to the very poor, and suffered from political isolation. In addition, the centralization of decisionmaking power in the executive generated negative externalities for the sustainability of reform. Although centralization was initially expedient, helping governments win speedy approval for their policy initiatives, it also resulted in the loss of the “pedagogical value” of congressional discussions and helped frustrate the public’s expectation of more transparency and participation, especially in the privatization program.

**Egypt**

In the 1980s the Egyptian economy struggled with persistently high inflation and severe budget and trade deficits. In 1991 the Mubarak government launched a comprehensive structural adjustment program to address these problems and the inefficiencies of an outgrown public sector inherited from previous administrations. ERSAP, as the program was called, was supported by the IMF and World Bank, and targeted both stabilization measures and reforms aimed at trade liberalization, price and investment deregulation, and privatization. It also planned for the removal of various subsidies and public employment guarantees that, as legacies from the Nasser era of an “Arab socialist” contract, had come to characterize the extensive role played by the state in the economic and social life of the country.

By 1994 the initial phases of the program were considered relative successes. There was a significant reduction in inflation rates and in the budget deficit, as well as progress in deregulation and liberalization. Nevertheless, a substantial part of the structural reform agenda, including the politically difficult initiatives of privatization and state reform, still lay ahead, scheduled to be addressed by the third and last phase of ERSAP. The problem seems to be that the early successes did not translate into a strong support constituency for reform, precisely at the point when strategic cooperation and public endorsement may become increasingly necessary to further the reform process. The author argues that the years since the start of reform have corresponded to an increase in political and social unrest in society. It is the discontinuity between successful economic performance and political difficulties that provide the central focus of this chapter.

Ibrahim shows that much of the opposition to governmental policies is of religious inspiration and not always explicitly connected with economic reform. The number of violent militants is actually receding, and the government remains in control of the means to maintain order and authority. The Islamic Movement that directly confronts the government, however, is gaining increasing support in society and its ranks coincide with the immediate losers of reform. This coincidence represents troubling signs for the future of the reform process.

Two explanatory factors from the author’s argument can be highlighted. On the one hand, the delaying of adjustment initiatives led to deterioration of the economy, rendering the reform measures more costly and more difficult to implement. On the other hand, the government’s reluctance in articulating a comprehensive reform message that could have made the goals of the new policies intelligible and their costs more acceptable contributed to society’s alienation from the adjustment efforts. Ibrahim suggests that confronted with the legacies of two powerful and contrasting previous visions, those of Nasser and Sadat, which had both succeeded in mobilizing the country, but eventually failed to deliver their
promises, President Mubarak was not inclined to repeat the effort. Rather than manipulating hopes, he announced his preference for delivering results. Nevertheless, when reform was finally initiated, after a decade when the material conditions of the population had further worsened, the vision vacuum had already been filled by the growth of the Islamic Movement. The author’s conclusions suggest that successful prospects for the economic reform process call for efforts to make its costs understandable and its benefits understood and appreciated by the public.

Ghana

Ghana’s economic reform experience has been hailed as one of the most successful in Africa. The chapter on Ghana contrasts two separate adjustment efforts. The first took place in the late 1960s; it was unsuccessful, and later reversed. The second was launched in the early 1980s; it has achieved substantial success, but has been facing difficulties since the beginning of the present decade.

Ghana’s economic policy regime in the immediate postindependence period was characterized by state-led import substitution, with a vision of eventually establishing an industrial socialist state. The support base of the regime consisted of urban interest groups, especially politicians, urban classes, workers and managers of state enterprises, traders, the military, and the bureaucrats. The regime also co-opted large-scale farmers through the use of selective incentives. The main losers in this regime were small-scale farmers. State-led import substitution implied a rapid expansion of government expenditures, whereas government revenues were stagnant and depended on cocoa exports and import taxes.

The first reform effort took place in 1967-71, which included attempts to liberalize imports and restrain domestic demand. The effort was not successful for several reasons. First, the government was not, and did not appear, committed to reform. The government did not have a clear agenda, and was not able to provide a consistent alternative to the “Nkrumah myth” of socialist industrialization. It was divided on economic policy, and it was perceived as indecisive. Without comprehensive reform, and with the help of booming cocoa prices, the government embarked on an expansionary program without attempting to eliminate the economy’s deep dependence on cocoa revenues and exports. Reform policies were weakened through several concessions given to the urban constituency. Finally, the reform package did not generate sufficient support from the donor community, and the government could not tap international financial resources. When cocoa prices tumbled in 1971, there was a crisis, a coup, and a reversal to a controlled system of economic management.

The second attempt to reform started in 1983, after more than a decade of general economic deterioration, and years of negative economic growth. The state had progressively lost its capacity to implement controls. Most economic activity, especially among cocoa and small-scale farmers, had moved to the informal economy, dramatically shrinking government revenues, which further eroded the governance capacity of the state and diminished the availability of rents that could be transferred to the urban constituency.

Reforms were undertaken under the leadership of the Provisional National Defense Council (PNDC). This effort differed from the earlier one in several respects. A critical component of reform was a conscious and successful effort to increase tax (non-cocoa) revenues. To improve tax collection, special units were created in the government, with enhanced pay conditions. Another was to create interest groups to further reform and control resistance (especially from workers). In particular, Workers’ Defense Committees (WDCs), which were organized at the shop floor, and were represented in public boards and institutions, became the center of expression of workers’ interests, and allowed the government to man-
age worker discontent as well as sell the program to the public. At the same time, the program was technically sound, and the economic team behind the program seemed strongly committed and unified. The fact that there was a significant amount of “prior adjustment,” whereby transactions would take place at black market rather than official prices, facilitated the task of policymakers. Significant progress was made, especially in trade, the exchange rate, and fiscal reform.

The program gained substantial support from the donor community. Nevertheless, argues Jebuni, credibility abroad was matched by a credibility gap at home. While the government’s anti-capitalist rhetoric prior to reform caused the private sector to remain skeptical, the availability of external assistance meant that the government could avoid relying on the private sector for the success of reform. Private investment response has remained weak, the private sector has not been integrated into the reform program, and it has not become an important source of political support. The main source of support for the regime remained heavily dependent on the state, and the government’s vulnerability to the demands of urban masses was not reduced.

Despite significant retrenchment in the public sector, attempts to reform and improve the capacity of the civil service did not succeed. Lack of control and monitoring of expenditures, procurement, and state contracts created fiscal slippages. The transition to multiparty competition in the 1990s created additional pressures. The government responded to wage demands by a 60–100 percent salary increase for the civil service in the election year of 1992, with spillovers to the public sector as a whole. This, coupled with increased laxity in discretionary expenditures and a slowdown of donor financial support, resulted in a loss of control over budgetary accounts.

The initial success of economic reform in Ghana was the result of leadership’s determination to resolve the economic crisis and their ability to convince international donors of their commitment. This proved inadequate, however, to support Ghana’s full transition to a market economy. It seems that the most important governance problem was related to difficulties in promoting constituencies that would have a stake in the development of such an economy.

Pakistan

In 1990 the Nawaz Sharif government came to power, signaling the emergence of a new proreform coalition, intent on displacing the extensive system of regulations that had characterized the economy for two decades. This new coalition, however, brought about only a partial power transfer to new promarket groups. Both the government’s mandate and its capacity to implement change were constrained by not introducing fundamental disruptions in the traditional power bases of major groups in society.

One of the early challenges of the reform was to tackle the fiscal deficit, which had grown to alarming proportions. The fiscal problem could be defined as a combination of downward rigidities in expenditures (defense, debt payments, and personnel) and a very narrow tax base, the result of widespread exemptions and tax breaks. Chief among these exemptions was agricultural income. Because defense and debt payments were also nonnegotiable, the only available option was to increase resource mobilization through broadening the tax base.

The chapter examines two different fiscal reform attempts, the first that of extending the reach of withholding and presumptive taxes, and the other that of broadening the tax base by eliminating exemptions and reducing tax rates. While the first of the two attempts was highly successful, the other failed in its major intent, leaving the government with the worst possible situation—lower taxes with a narrow base. The author examines the governmental strategy in the two episodes, as well the resulting structure of potential gainers and losers.
The main conclusion is that while the government could muster enough capacity and commitment in the first reform to successfully discredit the opposition and mobilize support with an intelligible formulation of the benefits to be accrued, it did not manage to display the same capacity in the second reform attempt. In the first attempt, expanding withholding and presumptive taxes to different kinds of specific incomes (such as dividends, interest, and export earnings) or proxies of incomes (such as electricity bills) was presented as an effective means to deal with tax evasion and corruption in the tax collection bureaucracy. The government was able to harness the support of business, which was convinced that rather than pay bribes, they would prefer paying taxes. Finally, the main losers (tax evaders and corrupt tax officials) could not reveal themselves, and therefore could not form an organized opposition.

By contrast, the losers in the second reform attempt were specific and vocal groups, including the powerful landlords who dominated most seats in Congress. The gainers were diffused and not mobilized. The government made a strategic mistake, and introduced rate reductions before securing reciprocal support for the elimination of exemptions. It also showed a much more ambivalent disposition toward maintaining the effort once the difficulties emerged. In short, capacity did not live up to the task of overcoming the obstacles in the main part of the reform.

**Turkey**

Turkey was one of the early success stories in adjustment. In the midst of a deep economic and political crisis, Turkey embarked on an ambitious program of stabilization and economic reform in 1980. The aim of the program was to transform a highly controlled and protected economy, led by import-substituting industrialization (ISI), into a market-driven, export-oriented economy where the private sector would play a leading role. Reforms in foreign trade, the financial sector, and international financial transactions continued in a generally consistent manner throughout the 1980s. The main economic policy problem that was not resolved was macroeconomic instability. In 1994, Turkey was once again hit by a major macroeconomic crisis, and had to implement once again a quite stringent stabilization program. At the root of the crisis were fiscal deficits, with public sector borrowing requirements reaching 12 percent of GNP in 1993. The chapter on Turkey examines the factors that led to the fiscal failure.

The prereform economic regime was characterized by a consensus among major political parties and interest groups on the basic premises of ISI. State intervention was extensive, both to promote industrialization and for political purposes. Particularly after the establishment of multiparty competition in the second half of the 1940s, using state resources to win political support became a major means of political competition. Employment in the public sector and agricultural subsidies were both important instruments of building political support.

Most of the earlier components of the stabilization and structural reform program were undertaken in an environment where political competition was restricted, and distributive demands could be suppressed. In 1980–83 there was a military regime. The first elections were held in 1983, but restrictions on political competition were only gradually lifted by the late 1980s. This political environment facilitated the initial macroeconomic stabilization in 1980–82, which was achieved by a significant redistribution of income from wage and salary earners and agriculture. Until the late 1980s, real wages and salaries declined, as well as subsidies granted to agriculture.

As political restrictions were eased, however, and the intensity of competition between political parties increased, it was no longer possible to remain unresponsive to distributive demands. After years of erosion in real wages, public sector workers successfully bargained for significant wage increases in 1989. This was followed by
further increases in the following years, along with upward adjustments in civil service salaries. At the same time, with political competition, agricultural producers reemerged as an important voting constituency; as a result, subsidies to agriculture, especially in the form of high support prices, increased as well. The resulting deficits were primarily financed by public borrowing. With the added burden of interest payments, the deficits became unsustainable, causing a major financial crisis in 1994.

The chapter argues that fiscal failure originated in a failure of governance capacity, especially in the state's inability to provide norms and mechanisms of cooperation so that political competition would be carried out in a less predatory manner. Resolving the fiscal problem and achieving long-lasting macroeconomic stability would have required either an understanding between political actors to limit the use of state resources for the purposes of political competition to less destructive levels, or structural reforms, especially in state-owned enterprises, the civil service, and agricultural support policy, to make fiscal policy less vulnerable to the vagaries of political competition. Neither was achieved, or even seriously attempted. The reforming governments' tendency to centralize decisionmaking in the prime minister's office, bypassing both the bureaucracy and the Parliament, and in general to increase the degree of government discretion over state resources, may have undermined any capacity to instill cooperation between the political actors, or between the government and the opposition parties, on the basic fiscal rules of political competition. The chapter argues that this failure to provide norms or mechanisms to support cooperation, especially in periods of tension, is a persistent deficiency in the political system that predates the reform period, and is possibly one of the factors that precipitated the economic and political crisis in the late 1970s.

In Turkey, failure in the fiscal area has been coupled with significant achievements in other areas of economic reform. Most important, there seems to be a widely shared consensus about the desirability of a more open and internationally competitive economy and the general trend toward market orientation. The private sector's demands for protection for the sake of the development of national industry are no longer seen as unquestionably legitimate. There is an increased appreciation of entrepreneurial activity. These changes are likely to introduce irreversibility into many aspects of economic reform.

_Brazil_

Throughout the 1980s, Brazil consistently postponed adjustment, at ever-increasing costs in macroeconomic instability. The successive stabilization plans of the period, although different in their orientation, never managed to reverse the root causes of disequilibria: the accommodating monetary policy and a growing fiscal imbalance. As a result, inflation soared, and growth and investment rates contracted sharply. In addition, no serious initiative took place in this period to change the country's inward-looking, debt-financed, and state-directed industrialization strategy.

The Brazilian history of postponed adjustment was also a history of deteriorating governance capacity. The anticyclical responses to the external shocks of the middle and late 1970s had resulted in an overextension of the scope of state activities in the economy, and a corresponding increase in the extent of penetration of the state by private interest groups. The state was thus locked in a pattern of interest group politics and conflict management that consumed sizable amounts of public resources. The eruption of the debt crisis, and the sudden and significant reversal in the net resource transfer that followed, however, placed severe constraints on the financing of the public sector. As the performance of the economy deteriorated in the 1980s, the political dispute over captured rents became more acute and predatory; but by then the capacity of the state to exercise any leverage in the political coordina-
tion of conflicting interests to introduce effective adjustment measures was severely compromised. Policy formulation, deprived of a sense of direction, became mainly defensive, pegged to a short-term survival logic.

The 1980s also witnessed the country's return to a democratic system of government after more than twenty years of military rule. This long overdue democratic transition actively engaged the attention and the energy of the society, and succeeded in effecting substantial policy changes in the institutions of the government in a gradual and peaceful way. Nevertheless, the chapter shows how the political transition, unfolding as it did in the context of a badly performing economy and a weakened state, further complicated the prospects for sustained adjustment by accentuating the fragmentation of state resources in the political system and the loss of governmental control over instruments of economic policy.

Starting in 1990, spiraling inflation rates and widespread perception of economic crisis brought successive proreform governments to power, and rapid and considerable advances in trade liberalization and deregulation took place for the next four years. The productive sector of the economy responded well, and restructuring efforts resulted in strong productivity growth. Nevertheless, acute macroeconomic disequilibria persisted, with monthly inflation rates reaching almost 50 percent by mid-1994, underscoring the persistent incapacity of governments to control public sector accounts.

This chapter argues that the true challenge of adjustment in Brazil has been—and still is—fiscal reform. It is also in the fiscal area that the debilitated state capacity is most clearly evident. One of the core purposes of this chapter is to demonstrate the extensive fragmentation of fiscal resources and the reduced policy space for fiscal adjustment that resulted from the rigidities and multiplicity of earmarking mechanisms introduced by the 1988 Constitution. This Constitution, the hallmark of the democratic transition, reflecting its strong distributive emphasis, was elaborated with no orienting parameters by a large and uncohesive assembly of politicians, who disaggregated societal demands and overheated expectations, making few realistic provisions for these demands and expectations to be met. Hence, fiscal reform became contingent on politically difficult institutional and constitutional changes.

In 1994 yet another, and considerably more successful, stabilization plan was launched. In sharp contrast with the experience with past stabilization initiatives, President Cardoso's Real Plan managed to drastically reverse inflation rates and stabilize the economy in the short run. Nevertheless, in spite of these achievements, and notwithstanding the clear signs of an ongoing regrouping of state capacity under the politically competent leadership of the new president, one year after the plan was launched, successful attempts to promote fiscal reform remained elusive. This chapter also includes a brief critical assessment of the yet vulnerable accomplishments of the Real Plan, and of the performance of the government in what so far seems to be insufficient efforts in political communication.

A Review of Main Themes

Institutional and Intangible Aspects of Governance

As can be seen from the summaries, the nine case studies identified different governance problems affecting the course of reform. The shortcomings of an unprofessional civil service, with recruitment and promotion criteria frequently based on political patronage, figured prominently. In addition, some of the chapters posit a close relationship between governance capacity and the fiscal performance of states. The government's ability to raise resources to accomplish its policy agenda and to resist predatory demands from interest groups to maintain fiscal stability are treated as indicative of governance capacity. States that allow substantial capture of their fiscal resources are seldom able to promote reform. Conversely,
the state's ability to expand its revenue base can increase its potential maneuverability for adjustment, making it possible to compensate losers.

Nevertheless, aside from the more familiar institutional constraints, most of the authors found that less tangible aspects of the exercise of capacity made a significant difference for the prospects of reform. Some of the definitions of governance advanced explicitly refer to these aspects. In the chapter on Egypt, Ibrahim contends that "governance capacity can be defined as the capacity to mobilize, control, regulate, and coordinate to get things done. As such, it entails the elite's mastery and deployment of the means of inspiration (vision), as well as the means of coercion (state violence or terror), with a host of other institutional means in between (for example, legislative, judicial, media, or civil society)."

In the Malaysian case study, the authors maintain that the exercise of coercion should be differentiated from governance capacity, although the former could be instrumental to the latter. For these authors, governance "denotes the ability of a state or a regime to govern based on a [sufficiently recognized] claim to legitimate authority"; and it "refers to the ability of a state to set, shape, offer, gain acceptance of, and implement its agenda." High capacity regimes are those that "can consistently gain a sufficiently broad acceptance of its agendas in competition with alternative agendas," and can frame those agendas as "national" and universal, regardless of whether or not they serve "limited ends or narrow interests." The success of adjustment programs, which may only be able to promise "future gains in exchange for immediate pains" to portions of the population, may be largely contingent on whether the regime of the leadership’s vision "can be shared rather than imposed."

The main thrust of the chapter on Brazil is in explaining the set of institutional constraints blocking reform efforts and the exercise of governance capacity. Yet the chapter contends that "reducing the problem of the state to the quality of its institutions may leave uncharted a number of variables that affect its capacity, such as leadership, political will, the exercise of authority, and political strategy, or statecraft . . . Governance capacity at any given point could be thus explained by the interaction between the institutional, and the less tangible, more volatile behavioral attributes and capabilities of the state.” Several components of governance are identified, such as the ability to politically coordinate interests that effectively constrain the policy process, and the capacity to convincingly represent policy decisions as representative of the public interest. The implementation capacity of governments is not only contingent on available technical and administrative resources, but also on the consistency between decisions and means, or the quality of the information held by policymakers over these resources. Implementation capacity supposes a minimal operational autonomy of the bureaucracy from the ad hoc and arbitrary influence of private interests; but capture of state resources also undermines legitimacy and constrains the capacity of states to coordinate disputing interests and exercise leadership.

Effective and representative governmental institutions are important insurance against the unpredictable intangibles of governance, but they can never fully compensate for the latter. This is particularly true in leadership, its credibility, and its communication capacity. Reliance on leadership makes for an awkward policy prescription, and yet its pivotal importance in reform processes that entail considerable institutional change comes across quite clearly in most chapters of this volume.

Navarro, in his study of Venezuela, contends that "governance capacity encompasses both the bureaucratic ability to design and implement reform and the leadership and the symbolic capacity to build and sustain coalitions that can support reform effectively and sustainably. A crucial
component of the effective exercise of leadership is thus the ability to convey a sense of the purpose of the reform process... so that an adequate public perception of the links between reform and national goals and values can be formed.” Leadership also refers to the state’s ability to maintain the fundamental trust of its citizens in the governmental and political institutions. The author argues that, by the mid-1980s, the Venezuelan state suffered from a serious legitimacy crisis. Citizens’ mistrust of these institutions had reached acute levels, making the task of generating support for any kind of reform project extremely difficult. The study on Brazil also suggests that governance is largely dependent on the “leadership capacity to make and sustain choices that may involve high political risk, and its ability to communicate to society the general direction of the policymaking process, also providing consistency to this process across the different areas of government.”

As the Ghana chapter demonstrates, reform may be affected by the credibility of policies, as well as of leaders. And insofar as credibility lies in the state’s capacity to induce the expectation that it is capable of making good on its promises and policy announcements, credibility can also derive from the accumulated experience of repeated interactions. Nevertheless, such experiences are not always available, and credibility ultimately hinges on the ability of leaders to persuade and communicate. It is also interesting to note that although it was the emergence of politically able leaders that have made possible the launching of reform everywhere, the credibility of these leaders was not based on any necessary affinity between their past ideological inclinations and the orientation of reforms. The adjustment program in Bolivia was finally launched under the presidency of Paz-Estenssoro, who took charge of rapidly dismantling the system of state corporatism he himself had been responsible for putting in place decades before. Ghana’s President Rawlings, whose popularity as a leader was associated to his socialistically inclined views, has been in power since the beginning of the reform process in his country.

Visions and leadership are inextricably linked. Vision creation was treated in these studies as either a means to enhance capacity, or as an integral aspect of it. Frischtak, in her case study of Brazil, argues that visions are “power-generating mechanisms” that “can fulfill the important institutional function of providing a bonding language of shared values to society.” In particular, she argues that visions may provide states with a means to break out of capture by interest groups. In the case of Venezuela, effective visions were treated as means through which the reformers could have compensated for the leadership and symbolic shortcomings of the Venezuelan state. The legitimacy crisis of the state had made it all the more crucial for the reformers to develop “a political message that connected with the values, hopes, and language of Venezuelan citizens.”

**The Technocratic Approach to Reform**

Governance capacity is also undeniably contingent on performance. The authors of the Malaysian chapter argue that as governance can facilitate adjustment, governance capacity will also be impaired if the regime fails to attain its stated policy goals. As the chapter on Malaysia suggests, “visions endure and captivate to the extent that experience suggest that they work.” Nevertheless, the conceptualization described above seems to confirm the view that culture—as a language of shared values and a way of representing social experience—constitutes the glue that holds societies and their institutions together. No material benefits that reforms can deliver, or promise to deliver, can be rendered meaningful unless translated by this language of culture, and no radical change in policy orientation or project of institutional change can be accomplished unless societies can culturally connect with them.

These observations can point to obvious enough factors, and yet most of them have been disregarded in many adjustment experiences. In-
Indeed, it is possible to detect a clear tendency among modern-day reformers, even those who have succeeded in inspiring credibility, to discount the importance of values, culture, and active political communication. These reformers have more often than not steered away from big ideas and announcements of encompassing changes. Policies are instead presented for their purpose in enhancing economic efficiency and rationality—“engineering values,” according to Morales, which do not necessarily have much cultural resonance within societies. One can think of several reasons to explain this trend. It could partially be the result of a contemporary distaste for the ambitious development plans of the past, or the older pattern of manipulative, populist politics that reforms often set out to displace. It could also be interpreted as an expedient strategy to introduce quick topic changes without too much political noise, in the hope that they would be irreversible later. And it could also be in line with the down-to-earth, risk-averse political culture of the adjustment leaders and their economic teams.

Nevertheless, it is often possible to detect in these approaches the mistaken premise that the benefits to be accrued from reform are self-evident, regardless of politics and culture; that the new policies can be accepted at face value; and that governments can operate in a sanitized, value-free, ideology-ridden environment. In many cases, this approach has resulted in a negative policy agenda, where the strong emphasis is placed on removing institutional constraints, rather than building new institutional anchors.

Calling attention to the limitations of such a narrow technocratic approach to adjustment will stand as one of the main contributions of this volume. Indeed, the approach has often backfired. The case of Venezuela provides the best example thus far of how government utterly failed to capitalize politically on early and substantial gains from the reform, simply because these gains were not inherently meaningful. Whereas the political impact of the accomplishments was mute, its costs were magnified by the existing culture, and it thus proved impossible to generate automatic constituencies for the reform program, leading to its radical reversal, and ultimately to the fall of the government itself.

In Bolivia as well, the initial support obtained by the reform government’s quick and impressive victories in curbing hyperinflation gradually faded as the past crisis receded into oblivion, and the government proved unable to identify a set of enabling values to fashion a reform message that could renew its mandate for difficult institutional changes. Morales cites solidarity as one possible such culturally enabling value.

The strong grip that ideas have on behavior, quoting Van Arkadie, is most visible in countries that have been home to powerful national ideologies, or visions, in the past. In Tanzania, the resilience of old ideas, especially in the civil service and among the political leadership, has significantly contributed to cripple the economic reforms. In Brazil as well, a strong political culture of import-substitution industrialization, which had successfully associated economic self-sufficiency to national sovereignty, was one of the major factors behind a lasting resistance to economic policy changes.

Malaysia is the one case study in this volume that provides evidence of effective vision-making. In our sample, Malaysia is also where reform efforts were most successful, although this does not suggest that our original hypothesis underwent any serious “testing.” The chapter on Malaysia discusses the different roles visions can play in supporting major economic policy changes. The vision-making during the New Economic Policy prescribed and guided the implementation of a comprehensive program of redistribution, and it provided an ex-ante argument to generate its acceptance. By contrast, “vision 2020,” the leadership’s post-1990 national development policy, followed a major change in the economic policy regime, and consolidated the successful policy adjustments. This distinction between the
role of visions in initiating reform, and consolidating or assuring its sustainability over time, appears in the other case studies as well. Another clear statement of this distinction appears in the Venezuela case, where Navarro argues that effective vision was not necessary for establishing short-term macroeconomic stability, or even for the implementation of structural reforms, but was needed to sustain them over the long run.

The case studies suggest that the importance and effectiveness of visions, communication, and persuasion, or the ability to change perceptions, can be assessed at various levels. At a practical level, communication is necessary to explain and clarify the objectives and effects of reform, which are not self-evident and are often misunderstood. In Bolivia, for example, privatization was stalled because it was perceived to benefit only the elite. In Ghana and Tanzania, devaluation was partially resisted by the leadership because it was believed that it would hurt the poor. The case studies also confirm, however, that political communication works at a deeper, more complicated, and more important level as well. First, the benefits of reform may not be made meaningful and desirable unless they are couched in terms that take account of established values. Both the Malaysian and Bolivian studies emphasize how important it is for the leadership to convey a sense or message of fairness.

Second, market-oriented reform unavoidably challenges some of the established norms and values, and communication is essential to change them. In effect, it may be necessary to present a new social contract, a new set of social goals, and a new set of norms and expectations about the appropriate role of the state in society. Both the Ghanaian and Tanzanian case studies discuss how the prevailing “ideology” (in Ghana “the Nkrumah myth,” and in Tanzania the Arusha Declaration) has acted as a major barrier to reform. Among the case studies, only in Malaysia was the leadership able to effectively change people’s expectations about the role of the state in income and wealth distribution. Even though Vision 2020 did not prescribe the dismantling of the redistributive programs of NEP, but followed it, it was very effective in providing new social goals that effectively eliminated ethnicity-based redistribution from the social discourse. The case of Egypt provides the most compelling example yet of how the failure to provide the messages that can make reform culturally compatible and ideologically attractive can lead to the generation of a vision vacuum. While the government demurred in effectively communicating an enabling language of values for economic reform, the gap was filled by competing visions, most particularly by the rising tide of Islamic fundamentalism.

**Institutional Changes**

One other theme prevalent in many of the case studies is the centralization of decisionmaking authority as an expedient means to enhance governance capacity during economic reform. In many instances of economic reform, there is a substantial concentration of decisionmaking authority in the executive, and in a circle of technicians close to the executive. This has helped insulate the policymaking process from pressures and opposition from other political actors and interest groups. This tendency has been pointed out in earlier studies (for example, Bates and Krueger 1993, p. 462), and is confirmed in the case studies in this volume. In Bolivia, the initial program was prepared by only seven people. The presidential character of the regime, and that ruling coalitions were able to command majorities in the Parliament, enabled the reforming government to move “expeditiously,” and quickly pass reform legislation without much debate. In Venezuela as well, the powers granted to the executive by the Constitution enabled the swift passage of reforms. In Turkey, the reforming governments benefited first from restrictions imposed by the military on political competition, and then from the ability to issue decrees with the power of law, which minimized debate in the Parliament. In many of the
reform episodes, the traditional civil service is bypassed, and people outside the civil service but close to the executive are appointed to crucial positions. Thus, centralization serves both to circumvent the opposition of political competitors and to bypass the civil service, which is often seen to be inefficient, riddled with clientelism, and not supportive of the program.

While centralization and institutional bypassing have made its possible to introduce several reform measures, the case studies raise serious doubts of whether these are durable means of enhancing governance, or effective means of ensuring the long-run sustainability of reform. In the case study of Bolivia, Morales argues that to the extent that decisionmaking processes generate learning and dissemination of information, excessive reliance on centralized decisionmaking may reduce chances for generating support for the program. Discussion in the Parliament may have had pedagogical value, in that it could have enlightened the public and served the purpose of communication and information dissemination. Avoiding debate in the Parliament may thus have resulted in losses for the course of adjustment. In Venezuela, the reform program advanced remarkably well under the Carlos Andres Perez administration. The constitutional authority of the president alone, however, was insufficient to mobilize political support for the program. Without such support, the reform program was vulnerable to changes in the coalitions in the Congress and became prey to antireform political entrepreneurs. Too much centralization may also decrease the leadership’s ability to generate the necessary cooperation with political competitors. This was the case in Turkey, where excessive reliance on executive power created too much discretionary authority, increased confrontation between the government and the opposition, aggravated the cooperation problem associated with fiscal policy, and eventually contributed to the fiscal deterioration. It also created an image of personal rule, undermined the legitimacy of the reforming government, and contributed to the loss in its popularity.

In sum, then, the case studies suggest that the impact of centralization and institutional bypassing on the reform process may cause a series of externalities, depending on how reformers handle the other aspects of the political process.

In many cases, centralization of the decisionmaking process in the government should be seen as the reformers’ response to various deficiencies in the governance capacity of the state, such as those deriving from excessive bureaucratization, fragmentation of the legislature and the political parties, and the dispersion of power and other resources in the political system as a whole. More specifically, it may be seen as an attempt to regain control over the policy instruments and the policy process. As such, concentration of power in the executive, and the various mechanisms for bypassing the Congress and the civil service, simply underscore the inability to introduce institutional change in the state. As many of our case studies seem to suggest, the last stronghold of resistance to reform may lie in the state itself.

Confirming our initial expectations, the case studies suggest that reform of the state and the public sector constitute the major portion of the remaining reform agenda, and are among the most difficult targets to accomplish. In almost all the country cases, progress on privatization has lagged behind progress in other components of reform. In Brazil, achieving macroeconomic stability depends on reforming the Constitution, which most probably requires dislodging powerful interests from the state. In Turkey as well, macroeconomic stability has proved difficult, because restructuring of the public sector and agricultural policies has so far not been possible. In Ghana and Tanzania, civil service reform is identified as a crucial step in increasing the ability of the state to provide even the most basic services. In Bolivia, reform of the Social Security system is considered essential to increasing national savings, but so far progress has been minimal. In Pakistan, fiscal reforms, especially changing
the tax system, are seen as crucial, not only to correct macroeconomic imbalances, but also to finance infrastructure investments to support private investment.

A final theme that arises from the case studies relates to the relative difficulty governments face in pursuing macroeconomic stabilization and structural reforms. It has been customary to presume that as far as noneconomic constraints are concerned, macroeconomic stabilization is easier to accomplish than structural reforms. The case studies in this volume would suggest that this is not a comfortable distinction. Both Brazil and Turkey, for example, have made far more progress in trade liberalization than in finding sustained solutions to the problem of macroeconomic instability. There are examples where countries have achieved macroeconomic stability in the short run, only to face fiscal deterioration because of shocks associated with electoral politics (for example, Ghana and Turkey).

The case studies suggest that the distinction may have more to do with whether a sustainable solution to the problem of macroeconomic instability can be achieved without institutional changes. Institutional changes may be necessary if an important reason behind macroeconomic instability is the failure of governments to manage distributional conflicts. The country cases are replete with examples of institutions that play fundamental roles in distributive politics and prejudice fiscal policy. Examples are parastatals in Tanzania, marketing boards in Ghana and Tanzania, agricultural subsidies and support prices, and state economic enterprises in Turkey. In Brazil, the budget itself has become an inflexible mechanism that provides automatic access for various interest groups, and severely limits the capacity of the government to conduct fiscal policy. In such cases, sustained solutions to the problem of stabilization may require the restructuring of these institutions, and constitute an important component of state reform.

The evidence of the difficulties in promoting reforms in the state underscores our main argument that successful adjustment will also involve reinventing governance on a new basis. This can only be achieved as a result of a process where new principles and the new purposes they are to serve are culturally assimilated by society, and new institutional mechanisms for political coordination and conflict resolution are put in place. Chief among the requirements of structural adjustment is that the dispute of conflicting interests becomes less dependent on state resources—be they jobs, subsidies, major government contracts, or simply privileged access to the policy process—and takes place more effectively in the market. The transition itself is likely to be conflictual, and the resulting arrangements will reflect the possible accommodation of this conflict in each specific social context. Nevertheless, this transition will not take shape unless society is culturally engaged. The challenge of adjustment thus remains the building of effective constituencies for change.

**Concluding Remarks: Policy Implications**

Few today would challenge the assertion that many of the factors affecting the course of structural adjustment are of a political and institutional nature. Indeed, it has become standard to approach adjustment as essentially a political economy problem. Yet this approach characterizes a significant departure from the underlying premises that oriented and provided much of the appeal of structural adjustment reforms back in the early 1980s. It also has implications for policy analysis and prescription that are often not fully appreciated.
In its original conception, structural adjustment designated a simple set of policies to correct previous distortions in the economy, and thus induce investment and growth. It could be presumed to apply anywhere, regardless of the existing factor endowments and level of income of individual economies. It was also entirely congruent with mainstream economic theory, and not less so with the dominant ideological currents of the Reagan-Thatcher era, which ensured both its technical and political credibility. And still, the information and knowledge requirements of these reforms could be easily provided by international financial institutions.

The analytical faith in the validity and desirability of these reforms has not suffered any significant blows; on the contrary, the ranks of prereform policymakers and economists have consistently enlarged since the early 1980s. Nevertheless, the recognition of the importance of environmental constraints and that reform entails institutional change has rendered the usefulness of the single structural adjustment policy package severely impaired. To begin with, these constraints are to a large extent country-specific, and the universe of potential factors to be taken into account is necessarily broad, making the information requirements of any applicable and reliable “reform recipe” almost unmanageable. In addition, there is no hegemonic or consensual theory of institutional change available that could both guide and provide technical credibility to reform architects. And finally, multilateral financing institutions have no established comparative advantage in the understanding of the political processes that generate institutional change.

If the ideas presented earlier in this chapter are pertinent, processes of institutional change will not conform to pre-set designs, and their outcomes are inherently uncertain. Governments committed to lead these processes in society can influence but not control their course. If changes toward strong markets and a new role for the state are effective, their result, at any given point, “will differ substantially from any original blueprint: it will be as much an accommodation of the main disputes among the politically effective interests . . . as a synthesis of the new with the old elements of prevailing institutions and the general political culture” (Frischtak 1995, p. 30). This realization is no novelty, because the very concept of a market economy is only meaningful at a rather abstract level. The actual empirical references to this concept in Western societies comprise varied arrangements in the division of responsibilities between state and market, in the shape of regulatory instruments, the scope of compensatory mechanisms, and the nature of the supporting legal system.

The greater appreciation for the political constraints of reform in the international financing institutions has so far resulted in a corresponding expansion of the scope of policy advice and loan conditionality. Nevertheless, the delinking of this automatic connection could be in order now. A greater appreciation of the resilience of institutions to policy intervention and their complex connection with culture and values should lead to more caution, selectivity, and even a critical questioning of the effectiveness of this advice in non-technical areas. The understanding of the environment-specific and uncertain course of institutional change entails a shifting of gears in policy prescription from the original premises that countries were amenable to a single, predefined reform agenda, to a more demand-driven advice and support, configured to the characteristics of clients.

Structural adjustment may finally be coming of age, as local leaders increasingly adopt the adjustment agenda as their own, creating a new opportunity for a less conflictual, more balanced and productive relationship between international financing institutions and their clients. This is especially true in reforms of the state and other complex institutions. As societies and their governments find their own way in institutionalizing adjustment, international institutions can relin-
quish their role as agenda-setters and direct players in reform processes. Instead they may allocate resources, for instance, in crucially important information gathering and dissemination activities. Policymakers themselves can benefit enormously from the not easily accessible comparative knowledge of other reform experiences. Finally, governments could be assisted in developing effective communication strategies in order to generate the necessary constituencies for change.

Two concluding messages suggested by the research material in this volume can be mentioned. The first is quite explicitly the focus of many of the chapters: not even the best-qualified leadership, with the most genuine commitment to economic reform, can afford not to invest substantially in political communication. Many proreform governments seem to partake of a common culture that laudably distrusts aspects of politics that involve pyrotechnics and demagoguery. The same governments also often overextend their distrust, and do not fully appreciate that economic reform is essentially a conflicting and competitive political process, and that politics is first and foremost about shaping perceptions. Competent, credible, and committed leadership would rather see perceptions change because of the policy results concretely delivered; nevertheless, a significant change in perception is most probably necessary to render policy results visible, or even to bring these results about.

The second message concerns external actors, and it is only indirectly derived from several of the arguments in this volume. The case studies were not explicitly oriented to address the contributions of the donor community and the international financial institutions to economic reform processes. In addition, there are far too many aspects of the development work done by these institutions and the varied and complex bilateral relations of countries that may affect ongoing reform programs, but were beyond the proper concern of this research. It would therefore be absurdly pretentious to propose general and abstract behavioral guidelines. What these studies unmistakably suggest, nonetheless, is that attempts to intervene or exercise pressure in—and even directly influence the course of—ongoing political and institutional reforms in developing countries is utterly unlikely to yield any positive results.

Even in the best of conditions, reform processes will occasionally suffer setbacks, partially stall, and deviate from governments’ planned policy programs. These events are not necessarily evidence of derailment, but the result of trial and error, and of unavoidable political dispute and compromise in the generation of radically new institutional arrangements. The international community has played a significant role in disseminating the ideas of economic reform and demonstrating the need for it, and has even contributed in various ways to the emergence of new leadership to conduct reform processes. It cannot play a direct part in the complex institutional change that these processes entail, nor effectively anticipate blueprints for their results. There is still considerable learning that needs to take place about institutional change, however, and international financial institutions can bring crucial resources together to make this learning possible.
Bibliography


Reversal of Fortune: The Ephemeral Success of Adjustment in Venezuela, 1989–93

Juan Carlos Navarro

This chapter will examine the political and institutional determinants of the early success and later derailment of economic reforms following the structural adjustment program put in place by the Venezuelan government in 1989. The focus will be on the effect of governance capacity on adjustment responses, in keeping with the hypothesis that government capacity is a prime determinant of successful economic reform in developing countries (Frischtak 1993). As an analytical category, governance capacity encompasses both the bureaucratic ability to design and implement reform and the leadership and the symbolic capability to build and sustain coalitions that can support reform effectively and sustainably. A crucial component of the effective exercise of leadership is thus the ability to formulate a vision that conveys a sense of the purpose of the reform process—to the population as a whole, or to major groups within the population—so that an adequate public perception of the links between reform and national goals and values can be formed. Attention will also be given to the idiosyncratic characteristics of the Venezuelan policy that may have influenced the results of the process. This chapter will not, however, give a detailed factual account of the complex political and economic situation in Venezuela between 1989 and 1993. The level of historic and institutional detail has been kept to the minimum required for an adequate understanding of the general argument by a reader unfamiliar with the country.

The adjustment program in Venezuela was known for its comprehensive and orthodox nature. It was launched as a response to an acute crisis in both the balance of payments and fiscal accounts, but from the beginning it was designed to address not only the short-term goal of restoring macroeconomic equilibriums, but also to significantly affect the root causes of the distortions. To accomplish this, it was designed to restructure key governmental agencies, privatize state enterprises, liberalize trade, and eliminate subsidies and

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price controls to all kinds of inputs and products, drastically changing the inward-looking, import-substitution model that had been dominant for three decades and replacing it with an export-oriented economic strategy (see the excellent account in Moisés Naím 1993 for details concerning this and many other aspects of the Venezuelan case).

The program earned early praise for its fast and thorough implementation. It is perhaps one of the clearest examples of shock therapy in adjustment that can be found in the catalogue of recent experiences with adjustment processes in developing countries (World Bank 1993). No allegations of lukewarm commitment or uneven application of policies across sectors have been raised against those responsible for the design and implementation of the program. The specialized literature has questioned the fast pace of adjustment rather than to complain, as is the case for many programs, about slow and half-hearted advancement of reforms (Hausmann 1995).

The adjustment process in Venezuela was also unique in several other respects that augment the interest of the Venezuelan experience. It took place in a country with a solid democratic tradition that had proven resilient, even as other countries in the region fell under the rule of authoritarian regimes. It also had a substantial resource base made possible by the oil industry and received significant support from the multilateral banks and other international institutions.

At some point, however, things started to go wrong. Opposition mounted; key reforms stalled; support for the reform program, never strong, weakened even more. After five years of reform, a massive urban riot, two failed coups d’état, a president impeached, and an electoral victory by the most conspicuous opponent of economic reforms indicated that something had indeed gone awry with economic reforms, and cast doubt on the continuation of reforms in Venezuela. There is even a risk of a vicious circle of macroeconomic instability and repeated adjustment efforts in ever more adverse conditions.

One of the striking features of this outcome—and a fundamental contention of this chapter—is that it can hardly be attributed to the failure of the economic effects of the adjustment program, at least as these are usually assessed by the international community. Positive results came very soon—sooner than expected by the policymakers themselves—in several important areas, including the balance of payments; exchange rate; foreign exchange reserves; export performance; and, above all, growth. Even inflation was being brought under control. In structural reform, trade liberalization; elimination of price and exchange controls and input subsidies; and the termination of financial repression, as well as the restructuring of pivotal public agencies, such as the one in charge of port administration, were well advanced if not completed eighteen months after the program was launched. The privatization program, the reform in the agricultural sector, and the implementation of the social safety net lagged somewhat behind, but they were in progress, and a series of bills had been sent to the Congress to move forward in the field of tax reform and other sensitive areas that required legislative approval.

Thus, the argument that follows constitutes not an attempt to question the design or technical details of the economic measures taken by the Venezuelan government, but instead places emphasis on an analysis of the conduct of the political process that accompanied the technical side of economic reform. It is argued that the determinants of the political failure and eventual economic reversal of the reform process, in spite of its early success, can be found in the dynamics and institutional aspect of governance capacity; that is, in the institutional weaknesses and symbolic and leadership shortcomings of the Venezuelan state. By the late 1980s, both had reached a critical level, just at the time when they would be most needed, given the necessity of structural adjustment. On the institutional side, bureaucratic capacities to design and implement policies had become se-
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verely impaired in the public sector; in symbolic and leadership matters, the Venezuelan political system was navigating through a major crisis, which made the work of building and sustaining coalitions that could act as effective supporters of the reform program difficult.

This chapter is organized into six sections. The first provides background information about the development of political and economic conditions in Venezuela prior to the launching of structural reforms. The second depicts the critical economic conditions of 1988 and the circumstances that shaped the campaign message and early policy signals of the Pérez administration. The third, and most extensive, portion describes both the stabilization package and the structural reform program and considers their adequacy and shortcomings in presenting an effective vision, as well as the governance capabilities of the Venezuelan state during the first half of the presidential term; particular attention is paid to the political economy of tax reform. The fourth section goes beyond failures in the effective vision that informed the adjustment response to deal with the organization of opposition to reforms. The fifth part includes a brief review of the fate of reforms under the administration of R. J. Velázquez and the first months of the tenure of Rafael Caldera, with particular reference to whether the economic reforms were as irreversible as originally planned by reformers. The last section is reserved for some general conclusions.

The essence of the argument is that in the Venezuelan case, an effective vision was not a requirement of short-term restoration of macroeconomic equilibriums, or even of the vigorous implementation of an ambitious structural reform package, but it was indeed needed if the reforms were going to be sustainable in the long run. Even if the failure in sustaining reform can be attributed partially to events not directly related to the nature of the adjustment program, the weak governance capacity exhibited by the Venezuelan state rendered the reform-minded administration defenseless when serious political challenges arose.

This chapter is based on technical reports and recent political and economic analyses of different aspects of the Venezuelan reform process, as well as interviews with privileged witnesses.

Venezuela before 1989

By the end of 1988 the Venezuelan economy was in the midst of deep fiscal and external imbalances, which led to the implementation of a drastic stabilization program by the incoming administration of Carlos Andrés Pérez in early 1989. The description and analysis of the political economy of such a program is at the core of this chapter. Before detailing both the dimensions of the economic crisis at the time and the adjustment response, however, it is worth considering a set of contextual elements and previous developments that give a more adequate perspective on the events of the end of the decade.

The 1980s: Oil Booms and Economic Mismanagement

The Venezuelan economy has been dominated by the oil industry since the beginning of the century. No other economic activity has been comparable in profitability, size, or importance for the financing of governmental activities. Yet one of the paradoxes of the Venezuelan case, as Rodríguez (1991) has emphasized, is that the 1980s were years of economic decline for the country, as they were for the rest of Latin America, although the oil shocks that were
such an important factor in the negative performance of the Latin American economies of the time were positive shocks for Venezuela.¹

The explanation of this paradox can be found in economic mismanagement. The use of extraordinarily high oil revenues to finance a large expansion of state-owned enterprises during the 1970s contributed to the creation of a structural public sector deficit that was not sustainable once the price of oil went down.² Of course, the oil booms could not last forever; this would have been anticipated by more competent or less shortsighted decisionmakers than those in charge at the time. Instead, the Herrera administration decided in 1982 to sustain the overvaluation of the Bolívar, while at the same time keeping interest rates well below the high rates in the United States, as the preferred instrument to fight inflation. That this policy was announced and sustained in spite of early and widespread warnings about its consequences suggests that it is plausible to interpret the behavior of economic policymakers as simple or less shortsighted decisionmakers than those in charge at the time. It decided to implement gradual devaluation and a multiple exchange rate regime that allocated dollars following a complex administrative procedure ruled by a set of priorities established by the government (Rodríguez 1991; Pacheco 1992).

These events are still, after more than a decade, the symbols of the beginning of economic hardship and reductions in the standard of living for the Venezuelan population. The multiple exchange rate regime turned into a device well-suited to postponing structural adjustment, as well as a hub of corruption, massive rent-seeking, and huge price distortions. Quite clearly, the traumatic economic events of 1983 would end up costing the party in power, the Christian Democrats (COPEI), the election. The Lusinchi administration (Acción Democrática, or AD), inaugurated in February 1984, took office. The actions of the new administration implied that it either defined its economic policies under the assumption that the country was suffering only a transitory lack of foreign currency, or it was completely unwilling to face the political costs of a structural adjustment process. Adjustment proceeded, of course, but reluctantly and without structural reform. In 1985, after several years of very slow or negative growth, the government launched a public investment stimulus package to be financed by a devaluation—a measure that in Venezuela automatically leads to an improvement in government accounts, because the government, through its ownership of the oil sector, is by far the largest supplier of foreign currency—and a set of marginal adjustments to con-

1 Between 1980 and 1985 the accumulated variation in gross domestic product (GDP) for all Latin American economies was negative. In this context, Venezuela represented a particularly acute case of economic decline, with a −20.8 percent growth over that period, the worst economic performance in the area, with the exception of Bolivia and El Salvador (Hausmann 1992).

2 Central government transfers to nonfinancial, state-owned enterprises averaged 3 percent of GDP between 1984 and 1990.

3 The most benign interpretation of this key episode in contemporary Venezuelan economic history is that the government had what could be described as difficulties in the timely adaptation of economic policy to changing external circumstances, which in turn could be explained by the good results that “traditional” economic policies had produced for the country over the previous three decades, making it ill-prepared to face sudden changes in the international environment. Hausmann (1992) has argued that by the early 1980s the performance of the Venezuelan economy started to deteriorate as the consequence of a failure to adapt to changing external circumstances that made the exchange rate, public spending, and interest rate rules that had prevailed since the early 1960s obsolete. However, an adequate consideration of the political economy of policy responses in the early 1980s goes beyond the scope of this chapter.
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sumption and corporate income taxes. Thus, public investment went from 7.7 percent to 12 percent of GDP in one year (Pacheco 1992). At the same time, in an attempt to shield the population from the hardships of devaluation-induced inflation, the minimum wage was raised, a compensatory bonus was paid to salaried workers, and price controls were imposed on more than 100 categories of goods.

In the election year of 1988 the economy grew 5.8 percent, following a year of 3.7 percent growth; unemployment was at 7.3 percent, compared with more than 10 percent only two years before, indicating the success of the stimulus package. The costs, however, were extremely high: the balance of payments exhibited a deficit of 7.8 billion dollars, the fiscal deficit reached 9.4 percent of the GDP, and the Central Bank had lost 4 billion dollars in only one year, leaving the availability of foreign exchange reserves at a critical level (World Bank 1993). In addition, the economy had accumulated acute price distortions. By the end of 1988 and the beginning of 1989 these distortions became apparent with the appearance of generalized shortages of staple foods, while at the same time the governmental agencies in charge of monitoring price controls were borrowing staff from other ministries to cope with the complexity and costliness of controls. The coincidence of the economic and the political cycles in 1988, an election year, created the incentive to stimulate the economy at any cost to maintain the government’s popularity up to the last minute. That goal was achieved, and there was ample incentive to disregard the costs or the negative consequences—they would be the problem of the newly elected administration.

During the decade-long economic decline there was no shortage of warnings and dissenting voices. Roraima, a group of private sector managers and academics, produced a “Proposition to the Country,” calling for a reorientation of the economy toward export-oriented activities other than oil and a redefinition of the role of the state to make it less dirigiste, more efficient, and focused on activities other than those already covered by private initiative. The document was formally presented to President Lusinchi, but it was dismissed immediately, without debate or attempt at justification. The Presidential Commission for State Reform (COPRE), a public agency charged with both research and advocacy, produced a comprehensive blueprint for the reform of the economy and public administration during the Lusinchi term in office. COPRE successfully promoted several major political reforms, such as the enactment in 1989 of direct elections for governors and mayors, but never achieved success in influencing economic policies or the role of the public sector in the economy. It is a matter of record (Pacheco 1992) that the Central Bank repeatedly warned the executive about the economic unfeasibility and social costs of the implementation of the stimulus package between 1986 and 1988, but such warnings were systematically ignored by the president and the finance minister. In contrast to the Herrera administration’s behavior, which has been described succinctly as mismanagement, economic policymaking under Lusinchi seems closer to what Drazen (1994) has called “benign neglect”: the failure to adjust either because of a sincere belief that “the problem will solve itself,” making adjustment unnecessary, even counterproductive (in Venezuela, this translates into the expectation of a sharp new increase in world oil prices, as actually happened in 1973 and 1979), or the use of this same expectation as an excuse for an unwillingness to act.4

4 Several comments attributed to the president at the time by privileged witnesses seem to provide support for the first alternative. The actual behavior of the Lusinchi administration, however, and in particular its willingness to sustain clearly damaging and irresponsible macroeconomic policies to the very end of its term as an instrument for maintaining presidential popularity—a goal that was achieved—seems to suggest a certain dose of political manipulation of the economy more compatible with the second interpretation.
The Politics of Economic Mismanagement in an Oil Economy

All these economic processes were accompanied by political developments that are worth mentioning to reach a fuller understanding of the conditions surrounding the initiation of stabilization and structural adjustment in 1989. Particularly important is the legitimacy crisis that engulfed the main political institutions of the country: the political parties, central pieces of the whole decisionmaking and implementation structure of the Venezuelan state, were deeply factionalized and in disrepute, primarily because of the widespread perception of corruption that constitutes the common sense explanation of the paradox presented at the beginning of this section.\(^5\)

The importance of political parties in Venezuela can hardly be overestimated. They have represented the main instrument of political mobilization and representation during the past thirty-five years, as well as privileged channels for consensus building and interest aggregation. The parties, particularly AD and COPEI, which have alternated in power since the beginning of the democratic regime in 1958, can be considered the architects of the constitutional setting in Venezuela and its main source of support. It is important to take into account that seven orderly presidential elections, including four episodes of clear and legitimate triumph of the main opposition party, is no small achievement in a country plagued by political anarchy and authoritarian governments since it achieved independence.

The origin of contemporary political stability can be found in a political pact made by the main political parties and endorsed by the private sector, unions, the church, and other major interest groups. All these groups formally signed—and lived by—a commitment to accept election results as legitimate, whatever the results; to make major decisions only with widespread consultation and unanymity; and not to interfere with issues or policies considered vital by any of the parties. The pact granted a de facto veto power over a whole set of possible policies to all those included in the pact (Levine 1973; Karl 1987).

As universally accepted and formally enshrined in the Constitution of 1961, Venezuela became a democratic nation, with presidential and parliamentary elections every five years. The Constitution granted extensive powers to the executive, and little autonomy to state and municipal authorities. Electoral rules allowed for extremely strong influence by party leadership in the determination of who would get elected to the Congress, because citizens could only vote for closed lists of candidates, which in turn led to strict party discipline in parliamentary voting, given that members of the Senate or the lower chamber knew that to be reelected they needed to please the party leaders rather than be responsive to a regional constituency.

Single majority was the rule for presidential elections—and has remained so, in contrast to several of the original features just described—making possible the victory of the largest of a set of minorities. This actually occurred several times, particularly in the elections of 1963 and 1968. After a highly fractionalized beginning, however, AD and COPEI eventually became the dominant forces in the political system (Kornblith and Levine 1994), systematically winning elections and capturing a large majority of congressional votes, as table 1 illustrates.

For all its stability, in time serious problems arose in the structure and functioning of the political system. Several observers and scholars had warned from the beginning of the 1980s that the pact at the root of Venezuelan democracy had

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5 Regardless of how much corruption there actually is in Venezuela, corruption looms large in the public mind, probably as a result of the need to find a plausible explanation for what is perceived as the coexistence of substantial national wealth—in the form of oil—and continued economic decline.
become exhausted (Naim and Piñango 1984; Romero 1986; Rey 1988). Both AD and COPEI shared responsibility for the economic mismanagement that has been reported above, and in the process lost ever-growing groups of voters and became rigid and somewhat dated political organizations. At the same time, neither these nor any other significant political party openly advocated a significant reorientation of public policy, from the traditional, import-substituting, inward-looking model to a more open, export-oriented economy led by the private sector. The most exciting leadership offering to the Venezuelan citizen in 1988 was a former president, Carlos Andrés Pérez, firmly linked in the public memory to the years of prosperity brought by the oil boom of 1974.

In the meantime, the state bureaucracy, the public institutions that are the core of the ability of any government to effectively regulate public activities and provide social services and infrastructure, became captured and extremely inefficient. In a well-known pattern of institutional capture in developing countries (Paul 1991), the education, health, transportation, Social Security, communications, water, and even tax administration bureaucracies turned into ineffective organizations. They lost their ability to respond to problems and challenges, and sometimes even to deliver the services they were routinely used to produce, all at a time when they demanded significant resources and evolved into union-controlled operations at the service of their workers rather than the public. The unusual financial strength of the Venezuelan public sector made possible the development of these distortions to a degree uncommon in other countries, where the citizens enjoy less of a fiscal illusion than they do in Venezuela. The traditional financing of the public sector by taxes on the oil industry has meant that decisions to increase public expenditures have no direct relationship with tax increases, which are clearly perceived by the average citizen, thus decreasing the incentives to demand accountability from political representatives and public sector managers.

Such distortions were not unrelated to party dominance and the resulting generalized alienation from the main political institutions. On the contrary, they must be understood as a coherent pattern of political arrangements in which the strong

Table 1

National Electoral Results, 1958–88

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<tr>
<td>Presidency</td>
<td>AD</td>
<td>49.18</td>
<td>32.81</td>
<td>28.24</td>
<td>48.70</td>
<td>43.71</td>
<td>56.72</td>
</tr>
<tr>
<td></td>
<td>COPEI</td>
<td>16.21</td>
<td>20.18</td>
<td>29.13</td>
<td>36.70</td>
<td>46.64</td>
<td>34.54</td>
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<tr>
<td></td>
<td>Other</td>
<td>34.61</td>
<td>43.02</td>
<td>42.63</td>
<td>12.40</td>
<td>7.99</td>
<td>7.51</td>
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<tr>
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<td>AD</td>
<td>49.45</td>
<td>32.77</td>
<td>25.55</td>
<td>44.44</td>
<td>39.81</td>
<td>49.95</td>
</tr>
<tr>
<td></td>
<td>COPEI</td>
<td>15.20</td>
<td>20.86</td>
<td>24.03</td>
<td>30.24</td>
<td>39.81</td>
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<td></td>
<td>Other</td>
<td>35.35</td>
<td>46.37</td>
<td>50.42</td>
<td>25.32</td>
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Note: Figures in bold indicate winner of the election.

6 Strong criticism and detachment with respect to political parties is one of the outstanding characteristics of contemporary politics in Venezuela. According to a recent study by the Consejo Supremo Electoral, the top-level authority in Venezuelan elections, adding up militants and sympathizers of political parties, they reached only 25.3 percent of the adult population in 1990, down from 38.4 percent in 1983 and 48.7 percent in 1973. In March 1992, 48 percent of the urban voting population answered “none” to the question: “Which is the party whose ideas concerning how this country should be governed do you agree the most with?” The same figure in 1984 was 24 percent. For a detailed commentary of these and related facts, see Navarro 1995.
party dominance built into the working of the political system was the main foundation of its stability, as well as the origin of generalized clientelism, public sector overextension, and interest group capture, all of which led, by the mid-1980s, to a major legitimacy crisis.  

Initial Conditions and Adjustment Response: How Adjustment and Economic Reform Came to be Both Unavoidable and Embraced by the Pérez Administration

Early Surprises and Expectations Management

The macroeconomic imbalances created in the last years of the Lusinchi administration were large enough to become apparent by early 1989. On February 27, less than a month after the new administration had taken office—and before it actually implemented the stabilization package—large urban riots and widespread vandalism erupted in Caracas and other major cities. Triggered by a sharp rise in public transportation fees in a Caracas suburb, and magnified by early reports broadcast by all major TV and radio stations, the population in many poor neighborhoods and even some middle-class areas went on a violent rampage, looting shops, disregarding ineffective police responses, and arguably reacting to months of high uncertainty, food shortages, and anticipation of hard austerity measures. Order was restored only after army deployment and violent repression. In what time would prove to be a very influential event, the honeymoon with an administration elected by over 50 percent of the voting population had come to an unexpectedly early and violent end.

To the credit of the administration, the riots did not prevent the launching of the adjustment program and the initiation of comprehensive structural reforms. Before briefly reviewing these, however, it should be noted that the population was hardly prepared for the austerity measures that are the essence of a stabilization package. The previous administration had concealed the sharp deterioration of macroeconomic conditions, even to the presidential candidate of its own party, who would eventually win the election. It has already been said that food shortages had become widespread in the early days of 1989, and that price repression was becoming unsustainable. It can be argued that the economy was on the verge of very high inflation if not hyperinflation: during late 1988 and the first two months of 1989 inflation reached 4 percent monthly, in spite of severe and generalized price controls. The new administration took office just in time to intervene, making what was one of the largest social benefits of the stabilization package—avoiding a significant inflationary episode—a counterfactual that the new government would not be able to translate into political support for reforms in the years to come. In addition, neither the public persona of Carlos Andrés Pérez nor, for the most part, his explicit campaign message indicated that his ad-

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7 The expression "legitimacy crisis" is intended to imply that distrust in government and the major political institutions—particularly political parties, the presidency, the Congress, and the judicial system—had reached acute levels and was widespread among citizens by the late 1980s. It is assumed in this chapter that in such an environment, the search for political support and the very foundation of the capacity of any government to earn support and build coalitions face particularly difficult challenges. In the language of the recent developments of the economics of organization, we could trace a parallel between this kind of generalized lack of confidence in the workings of government by citizens and the inefficiencies that arise in an organization in which a minimum degree of trust in the sound exercise of authority ceases to exist (Kreps 1992).
ministration would adopt structural reforms in line with the so-called "Washington consensus." His first tenure had been marked by the oil boom of the early 1970s, and the consequent huge increase of state involvement in the economy. For most Venezuelans, Pérez was the father of the entrepreneurial state, of the steel and oil nationalizations, a leader implicitly or explicitly associated with high public spending and a unique rise in standards of living for all Venezuelans. During his presidential campaign, he reinforced this reputation, giving scarcely any clue of a change in either his economic orientation or intentions: he called the IMF the "neutron bomb" for developing countries, and openly praised the populist economic program of his close friend Alan García in Perú. In addition, Pérez belonged to Acción Democrática, a political party well-known for its advocacy of strong state interventionism, firmly linked to union power and other pro-dirigisme lobbies, and the party of Jaime Lusinchi, whose government had been anything but sympathetic to the functioning of market forces.

All this is relevant because it suggests that, whatever the benefits of the liberalization policies to be undertaken by the Pérez administration, the Venezuelans did not vote for them. They elected a charismatic leader associated with abundance, paternalism, and state interventionism who belonged to a social-democratic political party that had been the main force behind the development of the Venezuelan entrepreneurial and overextended state. When the Venezuelan citizens faced an adjustment program and liberalization policies, they had to be surprised. Very little in either their political culture or in the electoral process had prepared them for what was happening.

**Early Signs of New Directions:**
**From Unavoidable Circumstances to an Economic Reform Program**

Perhaps the first signal of the kind of policies to be adopted by the new administration was the composition of the newly appointed cabinet of Carlos Andrés Pérez. Pivotal positions in economic policymaking—the planning and the development ministries in particular—were now in the hands of people with predominantly academic or private sector backgrounds and little or no party affiliation. Even this signal, however, was not entirely clear, because the crucial position in the Ministry of Public Finance and other important appointments were put in the hands of people affiliated with the party and with a much more interventionist and mainstream Venezuelan economic stance—doubtless an attempt by the president to secure AD's support.

Another early signal was the willingness exhibited by the economic team to look for cooperation and support from international organizations. Depletion of foreign exchange reserves required IMF support, and an ambitious structural reform program could obviously benefit from

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8 Several economists who had the opportunity to talk to Carlos Andrés Pérez just a few months before the elections have reported the authenticity of such populist views about the economy. It is a matter of pending historical research to determine exactly when and how Pérez would change his mind and become firmly committed to liberalization and pro-market reforms. For the purposes of this chapter, however, it is enough to take into account both the role of his previous economic reputation as a populist in the evolution of public expectations concerning the eventual orientation of his administration and the fact that he actually, and from the very first day in office, launched comprehensive pro-market reforms that went far beyond the minimum adjustment required to reduce external and fiscal imbalances. For more on this issue, see Naim 1993.

9 The separation of party officials and technically oriented ministers with no party affiliation constitutes a characteristic of adjustment response in Venezuela that contrasts with several other cases, notably the Mexican experience, where the PRI structure somehow incubated a highly qualified new leadership that was eventually charged with the design and implementation of structural reforms. It is difficult to ascertain whether this factor is decisive for the political feasibility of reforms, but in Venezuela it certainly undermined the reform process by weakening the stance of the economic team and making it difficult to disseminate and explain the new economic orientation to the population. For a recent review of the political economy of policy reform that deals extensively with the issue of the role of technocrats, see Williamson 1994.
World Bank and Inter-American Development Bank (IDB) support. At the time, however, Venezuela had been isolated from multilateral cooperation since the early 1970s, a result of the oil bonanza, so this kind of support, in the context of an emerging “Washington consensus,” was quite a novelty in the management of economic policy in Venezuela.

The growing influence of the economic team on presidential decisionmaking, the pressure of economic imbalances, and the influence of international organizations would quickly combine to produce a structural reform program that would go beyond short-term stabilization goals to constitute a whole new reform program to be proposed to the country.

Early Successes and Critical Shortcomings: The First Three Years

The Stabilization Measures of 1989

The acute macroeconomic imbalances faced by the new administration generated an adjustment response that can be properly labeled “shock therapy.” Clearly the most important element of a plan would have to be a sharp devaluation, because the exchange rate applicable to most transactions—the multiple exchange rate created at the end of the Herrera administration remained in place with few changes—had been nominally fixed at Bs.14.50 per U.S. dollar since 1986. Indeed, in March of 1989 the exchange rate was unified and left free to float; all exchange controls were abolished.\(^{10}\) In addition, financial and price repression were simultaneously eliminated by lifting price controls and liberalizing interest rates, which jumped from 13 percent to around 35 percent. On the fiscal side, the central government brought its investment almost to a complete halt. It dropped from 3.2 percent of GDP in 1988 to 0.1 percent in 1989, and if current expenditures increased moderately, it was an effect of devaluation on external debt service rather than an increase in domestic expenditures, which remained unchanged (World Bank 1993).

An important part of fiscal policy during adjustment in Venezuela has to do with the translation of a devaluation into an increase in the PDVSA (the state-owned petroleum holding company) surplus in Bolivars, which flow directly through taxes into increased budgetary revenues for the government. Thus, between 1988 and 1989 the government revenue from the PDVSA surplus rose from 11.4 percent of GDP to 20.5 percent, mainly because of the sharp nominal devaluation. This increase in revenues generously compensated for the recession-induced reduction in tax receipts for 1989, substantially contributing to the almost equilibrated fiscal stance of that year after the large deficit of 1988.

Related stabilization measures included a renegotiation of the Central Bank exchange rate guarantees on private import letters of credit and payments of private external debt that reduced their burden from 10 to 4 percent of GDP, and the beginning of negotiations with international creditors to restructure the external debt of the public sector under the Brady Plan umbrella. Substantial support for the stabilization program was obtained from the IMF, the World Bank, and the IDB.

Short-Term Economic Impact of the Stabilization Program

The success of a stabilization program is usually judged by its effectiveness in deficit reduction,

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\(^{10}\) The exchange rate reached Bs. 39 per U.S. dollar less than one month after the elimination of controls. By the end of 1989, it had reached 43 Bs. per U.S. dollar. Such a nominal devaluation brought a real devaluation of some significance, which was gradually compensated in the following four years.
restoration of external equilibrium, and inflation control. On all these counts, the Venezuelan program of 1989 was an almost unqualified success. The fiscal deficit went down from 9.4 percent of the GDP in 1988 to 1.1 percent in 1989, and then to a surplus in 1990. The balance of payments exhibited a positive and drastic turnaround, particularly the current account, and reserve accumulation started at a fast pace, reaching $12.5 billion in 1990. Price liberalization and a 140 percent devaluation created a price shock in the second quarter of 1989, contributing to an 80 percent rate of inflation for that year, but from October onward the monthly rate of inflation was about half the prevailing rate in January and February. Table 2 contains information concerning the evolution of the main macroeconomic indicators in the years directly relevant to evaluating the short-term impact of the stabilization program of 1989.

In 1989 the GDP registered negative growth of 8.6 percent overall, and even greater negative growth in several important sectors, such as manufacturing and construction. Unemployment jumped from 7.3 to 9.6 percent, and real salaries fell by 9 percent. All this created an immediate increase in the poverty counts, which led the government to attempt to construct a social safety net to compensate for the social effects of adjustment. Nevertheless, given the low implementation capabilities of line ministries in the social area and the highly inefficient instruments that had been used to advance income redistribution, brand new, targeted antipoverty programs had to be designed and put in place, which delayed the beginning of compensation until at least seven months after the launching of the bulk of the stabilization program in March. Here, as we shall see repeated in other instances, the institutional and technical weaknesses of the Venezuelan state prevented the reformers from compensating the short-term losers of adjustment in a timely manner. After the initial delay, however, quite significant compensation would proceed.11

In spite of the initial difficulties, the short-term negative impacts of adjustment were rapidly reversed. Vigorous growth would resume, reaching 6.4 percent in 1990 and 10.4 percent in 1991. Unemployment would fall slowly but consistently until 1992, and poverty indicators showed some improvement in 1991 (Márquez 1993). In addition, international reserves kept growing. Nevertheless, the most visible indication that potentially

11 The PEP (Programa de Enfrentamiento a la Pobreza), initiated by late 1989, soon reached a dimension comparable to the Mexican Programa Nacional de Solidaridad in spending per capita. The Mexican program was generally believed to be a model social welfare program, and one of the key components of the political feasibility of the structural reforms undertaken by the Mexican government. For details, see Márquez 1993 and Navarro 1994.
serious medium-term stabilization problems remained was the persistent level of inflation, slightly above 30 percent. This, however, leads directly to the fiscal dynamics of the Venezuelan adjustment response that will receive a separate treatment below.

Launching Medium-Term Structural Reforms
Almost simultaneously with the implementation of the stabilization package, the Pérez administration decided to launch an ambitious structural reform program. It would take the opportunity created by the correction of the deep distortions caused by the mismanagement of the previous administrations and eliminate what the president and his closest economic advisers judged to be the root causes of such distortions: the inward-oriented import substitution model of development and its correspondent interventionist and overgrown state apparatus. The economy of the country was so thoroughly organized along interventionist lines that almost every aspect of governmental activities required profound changes. Not surprisingly, the VIII National Plan, written by representatives of the highly technical economic team, was named “The Big Turnaround.” A partial list of the reforms undertaken during the Pérez administration between February 1989 and May 1993, when the president was demoted by Congress after a Supreme Court ruling that there was sufficient evidence to indict Pérez for corruption, includes the following (Naim 1993; Torres 1993; World Bank 1993).

- Foreign trade regime. Called by experts “one of the most distorted commercial policies in the world,” the foreign trade regime was drastically reformed, eliminating all quantitative restrictions. The administration immediately eliminated licenses and prohibitions on 1,900 items accounting for 77 percent of manufactured imports and significantly lowered tariffs between mid-1989, when the maximum tariff reached 135 percent, and 1992, when 20 percent was the highest operating tariff. In spite of widespread fears that this would have devastating effects on local industry, the compensating effect of devaluation generally offset the effect of liberalization, and the large majority of industrial sectors either improved or maintained their previous performance and profitability, once the impact of the 1989 recession had faded (IDB 1992).

- Foreign investment regime. By January 1990 all restrictions to foreign investment were eliminated, with the exception of the oil, mining, and banking sectors.

- Privatization. After a slow start, privatization took a big leap forward with the privatization of the telephone company, CANTV. 40 percent of which was sold by the end of 1991. A major airline and several minor state enterprises and assets, such as banks and miscellaneous factories, were also sold. A well-defined privatization schedule was assembled showing the time and conditions for the sale of hotels and electric companies.

- Public sector restructuring. Several public agencies were reformed, either to make them more efficient or to create the conditions for later privatization. The INP, in charge of managing the seaports, was restructured and privatized in 1991, the water holding company was decentralized, the institute in charge of building public housing was restructured, and so forth.

- Social sector reform. Although it never tackled the issue of reforming the agencies in charge of social policies, the administration developed a pattern of new project implementation units devoted to the management of entirely new compensatory programs: direct

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12 This is generally believed to be an extremely fast trade liberalization process, which in three years accomplished what international standards normally assume would take seven years.
cash subsidies, safe motherhood and nutrition, school construction, microenterprise support, urban infrastructure for poor areas, and the like.

- **Financial sector reform.** Laws to improve the regulatory framework for banking and capital market activities were finally approved under the provisional government of R. J. Velázquez in 1993, but they were prepared and introduced in mid-1992.

- **Institutional reforms in fiscal and monetary policy.** A new Central Bank law aimed at substantially reinforcing its independence from the executive was passed by the end of 1992 at the initiative of the administration. A new Public Credit Law was also passed, setting strict limits on the power of Congress to authorize additional expenditures after approving the yearly Budget Law.

- **Institutional reforms in the price mechanism and competition.** New antitrust and antidumping laws were enacted in 1992, and corresponding agencies were created and staffed and were in operation by the end of that year. The existing Law for the Protection of Consumers was abolished, and the agency in charge of enforcing it was turned into an Institute or Consumer Education, which had no significant price-fixing authority.

- **Energy sector.** Apart from planned privatizations, CADAFE, the largest public electric company, started a restructuring process, and electricity rates were raised to put them in line with long-term marginal costs. Gasoline prices were gradually raised in 1991 following a previously announced schedule.13

- **Agriculture.** A sector that had experienced much intervention, agriculture was widely liberalized, with the elimination of trade restrictions, input subsidies, and price controls. There was strong public investment in infrastructure and the Agricultural Ministry was restructured.

- **Tax reform.** A comprehensive reform attempt was launched initially in 1991, without much success (the next section will provide details).

This impressive list of achievements can in part be explained by the extensive powers of the presidency in Venezuela, which allow for substantial reforms to be implemented by the executive without much formal approval by either the Congress or other levels of government. Other factors, such as the relative absence of organized opposition and the generous compensation paid to unionized public sector workers are elaborated below.

### “The Great Turnaround” as a Vision

The first thing that can be said of such a reform agenda is that it was highly coherent and comprehensive: almost every sector of governmental action was touched by reformist aims or actions, and this generally happened in a way that was consistent with the rest of the reforms. The common orientation of reforms was clearly to turn the economy into a competitive, export-oriented structure with much less intervention, with the public sector becoming much more of a liberal state, concentrated in market failure correction and direct redistributive actions. It goes without saying that such an orientation entailed a drastic departure from the traditional direction of the economy and the public sector in Venezuela.

Given these characteristics—coherence, comprehensiveness, and novelty—it can be argued that, beyond stabilization, the structural adjust-

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13 Gasoline prices are a particularly sensitive issue in Venezuela given the existence of a strong and widespread belief that Venezuelan citizens are entitled to cheap gasoline because the country is abundantly endowed with oil. It has been found that the gasoline subsidy is an extremely regressive subsidy: for every Bolivar that goes to a person in the lowest quartile of the population, four Bolivars go to a person in the highest quartile (Rigobón 1992). Still, the matter has proved to be literally impossible to handle politically in recent years, and the Pérez administration achieved some success in reducing the subsidy only for a short period of time and by adopting a very gradual price increase schedule.
ment program of the Pérez administration looked at first like a whole new vision concerning the future of the country and the way in which state-society relations would be organized in that future. It can be deduced from observation of the reformist drive and the analysis of its official synthesis—the VIIth National Plan—that Venezuela was to become a market-oriented economy, integrated with the world not only through oil exports, but also through a set of internationally competitive industries. A smaller and stronger state apparatus would be devoted to regulating private sector activity, but not to replacing it, and with public sector activity oriented to investment in public infrastructure and social services.

Yet, for the most part, this was the vision of the small group of highly qualified economists and managers that surrounded the president, and the vision of the president himself. Regardless of his radically different stance on economic policy during the campaign and his first term as president, Carlos Andrés Pérez would become a staunch supporter of reforms, and would remain so even under the most difficult political circumstances. Nevertheless, no organized political force supported the program: not a single party or political movement of significance in Venezuela has embraced a market-oriented economy openly as a guiding principle of its ideological platform. The closest case is COPEI, which does so rather mildly and, having lost the election in 1988, could hardly expose itself as the main supporter of the government.

Even AD, the president’s party, did very little to provide congressional help when it was needed. Many of its leaders openly distanced themselves from what Pérez was trying to do, and the party members who were appointed as cabinet members were, generally speaking, the less enthusiastic advocates of reforms. In order to understand this, it is important to take into account that Pérez had won the nomination after a bitter internal battle that left AD far from united in its support of the party’s official candidate to the presidency. Almost all positions of authority within the party at the time were in the hands of party officials who had been opposed to the Pérez nomination, and that would remain so even after the official announcement of his candidacy. Above all, however, it can be argued that the most powerful cause of AD’s lack of support for the economic reform program was ideological: they saw the increasing room given to market forces by the Pérez policies as incompatible with the social democrat and interventionist ideological tradition of the party.

Organized interest groups and influential social sectors also provided little support. At least as many businessmen were pleased by price deregulation as became alienated by the termination of protection and subsidies. Trade liberalization was begun with far less interest group opposition than expected, yet this does not necessarily mean that it received open support from the private sector, or any other social group. Given the immediate unpopularity of the reforms, illustrated by the events of February 27, it could be observed that even managerial groups ideologically committed to pro-market reforms were silent. This may perhaps be understood as a prisoner dilemma paradigm: they may very well have hoped to benefit

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14 AD’s behavior in Congress during the Pérez administration was formally supportive of the administration, in the sense that it never declared itself openly as an opposition force, but in practice it provided only lukewarm support or no support at all to several key initiatives, such as tax reform. It could have been a major factor in supporting reforms, because it had the largest minority in Congress, only a few votes from absolute majority.

15 The introduction of ideology as an explanatory variable at this point of the argument may look at first like an ad hoc device to fill a gap in the main line of reasoning. The author would prefer to interpret it as a fully integrated part of the argument, on the lines suggested by North: “Ideas and ideologies matter . . . Ideas and ideologies shape the subjective mental constructs that individuals use to interpret the world around them and make choices” (1990, p. 111).
from policy reforms without suffering the political costs of openly supporting an unpopular program. A new potential constituency that could have supported the reforms were export-oriented entrepreneurs, but this group did not emerge forcefully, probably because of a lack of time and the absence of direct actions by the administration to encourage them.

In any case, the weakness—a result of the legitimacy crisis—of the major and traditional channels of interest articulation, the political parties, made the whole process of exercising political influence extremely confusing and badly structured. Direct action by groups of the population, such as street demonstrations, and the direct and often unpredictable reactions of mass media to political and economic circumstances became the dominant forces in day-to-day politics. Surpassing the orderly and clearly identifiable interest groups, these would be the forces that would become dominant in the political dynamics that were about to engulf the Pérez administration and its reform program.

**Initial Constraints and Subsequent Failures in the Articulation of an Effective Vision**

The Great Turnaround represented a vision, yet it was probably so fragmented in many important respects that it can hardly be called an effective vision. As has just been illustrated, it could count in its favor ideological coherence, able design, a highly competent economic team, and strong presidential commitment. To this it might be added that, as the core of a new national project, it had a natural connection to contemporary developments in the international environment, such as the global tendency toward free trade and competitiveness, and it was consequently supported by multilateral organizations. Nevertheless, major constraints in the formulation and implementation of an effective vision were present.

Several of these constraints have already been mentioned: the complete unpreparedness of the population for the new policy orientation, given the contrasting nature of such orientation, and the legitimacy crisis that affected the political system, political parties in particular. There were other constraints: to the collective action problem that has been hypothesized to have affected even potential supporters of reforms, an information problem has to be added (Seabright 1994). The departure from traditional, long-standing, and well-known patterns of economic and governmental organization was surely going to generate uncertainty among individuals, firms, and organized interests concerning their role in the reform process and its end result.

Even if the administration’s claim that the new vision would improve social welfare could be taken at face value—quite a leap in a country with a political culture filled with deep distrust of the potential of free markets to achieve socially valuable goals—the radical innovations of the reform programs were a source of uncertainty. This uncertainty included the new economic role, social identity, and the welfare of each individual, particularly once the new economic orientation was put in place. It created a situation in which an inefficient equilibrium prevails, in spite of the realization of the potential gains of social cooperation (Mueller 1983).

In addition, it was at least reasonable for the public to think that the reform effort would become another short-term shift in public policy rather than a strategic turnaround. The public sector had earned this lack of faith, given the erratic macroeconomic management that had occurred over the previous decade. The administration did the best it could to combat this attitude. It took all available steps to reassure the private sector that the new policies were here to stay and that few or no deviations would be attempted or tolerated. The case of trade reform is paradigmatic in this respect: the drastic reduction in trade barriers was carried out across the board, and relatively quickly, on the assumption that granting exceptions to a particular sector or proceeding too gradually
would unleash a wave of rent-seeking that the institutionally weak and captured Venezuelan state would not be able to resist.

This instance is also revealing of one of the initial conditions of the reform process that created restrictions to the advancement of the program: the weak technical capacities of the public bureaucracy. By the time a professional and capable public service was needed for the new and complex policies that were being designed and implemented, public agencies in Venezuela, with very few exceptions, were extremely rigid organizations that had lost relevant technical skills. They functioned, for the most part, as textbook examples of capture, paralyzed and distorted by excessive union power and the extended practice of patronage politics. Not much could be expected in the way of professional management from such agencies as the Development, Public Finance, Agriculture, Social Welfare, Education, or Health Ministries. This led the administration to adopt a managerial strategy based on what can be called "institutional bypassing" (Navarro 1994); that is, the attempt, not always successful, to ignore the line bureaucracy that was supposed to deal with a given problem or program, and to create a new and parallel administration of highly qualified and well-paid personnel, able to effectively run the new policies.

In this connection, it must be observed that one of the reforms not attempted by the Pérez administration was civil service reform. Special ad hoc design and implementation units were set up in many sectors, often in close cooperation with multilateral organizations, but traditional bureaucracies were left untouched in the name of expediency, but also in what can easily be described as a deliberate attempt to avoid conflict with public sector unions. The reform program was intended to change the way the state functioned, yet it did not directly challenge the core of the economic organization and the politics of public bureaucracies. The balance between the need for fast results and substantial reforms was lost in favor of expediency and, it can be argued, political stability.\(^6\)

To this set of quite formidable initial constraints, the administration added its share of mistakes and limitations. As previously noted, the reputation and the outstanding campaign message of the president did little to counterbalance the unpreparedness of the population for a major turnaround of public policy. This failure would hobble the administration to its very end, and it has been widely recognized, even by top-level officials of the administration, that the failure to mount an effective communications policy, able to facilitate the acceptance of the reform program, was one of the major shortcomings of its implementation. Given the informational problems implicit in any reform attempt, poor handling of communications by the administration compounded the substantial transaction costs already attached to the implementation of the structural reforms.

It could be argued, however, that the problem goes even deeper than communication failure, at least as it is usually understood. In sharp contrast with the administration’s high degree of intellectual sophistication and the coherence of the economic program, the political message never received a comparable degree of elaboration, which was needed to transform the mainstream orientation of the country through a political message that connected with the values, hopes, and lan-

\(^6\) Naim (1993) contends that the decision not to affect the interests of the education, public health, and Social Security unions was explicitly made by the administration to avoid any further weakening of the already reduced political base of the government. It is, of course, a matter of debate whether this decision actually enhanced the political feasibility of the reform process by avoiding confrontation with extremely powerful groups, or undermined the reform effort: first, by creating easily perceived inconsistencies in the reform program and, second, by preventing the administration from using highly visible channels for the improvement of the social conditions of the population.
guage of Venezuelan citizens. The symbolic components of a vision are crucial to the conveyance of the acceptability of short-term losses as a necessary step to obtain corresponding gains at a later stage, and these components were extremely weak in the political discourse of the administration, if they were present at all.

This symbolic failure can be seen in a number of arenas. One that is particularly salient is the lack of perception of fairness in the sacrifices that the adjustment process required from different groups of the population, a crucial component of successful reform programs according to the literature (Nelson 1988). It has been mentioned that the development of a social safety net to compensate for the short-term social costs of adjustment was included in the reform package. With some delay, the administration would end up with the best organized and financed social welfare policy in the memory of the country, yet it is curious that the president and his cabinet were unable to extract political benefits from its creation. In contrast to the political support that emergency social programs have produced for reformist administrations in cases such as Salinas’ Solidarity Program in Mexico or Paz Estensoro’s Emergency Social Fund in Bolivia, the huge effort and talent invested and the overall good results obtained by the Venezuelan Plan de Enfrentamiento a la Pobreza were not able to prevent the perception that the administration was blind to equity issues. The problem was not that there was little concern for compensation for the poor, but rather that the administration proved itself unable to draw significant political support from its commitment to social policy. Other kinds of measures that have been powerful symbols to the population that even the privileged had been forced to make their share of the sacrifices—the perception in the stabilization program in Brazil that freezing bank deposits had been uniformly harmful for all social strata, the prosecution of powerful union leaders or businessmen in México—were absent or went unnoticed in the Venezuelan case.

The Political Economy of Fiscal Reform and the Problems of Medium-Term Stabilization

Beyond short-term successes, medium-term stabilization problems persisted; the control of inflation was the most important. After stopping the acceleration of inflation in 1989, and possibly preventing hyperinflation, the economy experienced rates of inflation a little above 30 percent in 1990, 1991, and 1992. Several factors contributed to this, but the most important was doubtless the persistence of the structural fiscal deficit caused by a chronically inadequate tax system. Venezuela is one of the countries of the world with the lowest fiscal revenues in relation to the size of the economy, about 5 percent of GDP, once one excludes taxes on the PDVSA surplus. Even though oil reserves and production potential have been on the rise over the last decade, the adequacy of taxes on oil to finance public expenditure has been gradually but significantly reduced by the fall in oil prices in the international market, as can be appreciated in table 3. Coupled with the growing needs of the economy, this has led to a substantial gap between revenues and expenditure.

Restrictive macroeconomic policies in 1989 led to a reduction in the fiscal deficit from 9 percent of GDP in 1988 to 1.1 percent. The budget surplus of 0.2 percent of GDP in 1990 that appears in table 2, however, hides the important fact that this figure includes the effect of a substantial rise in the dollar value of oil exports as a consequence of the rise in the price of oil that accompanied the Iraqi invasion of Kuwait. If this effect is taken out, a budget deficit

<table>
<thead>
<tr>
<th>Table 3</th>
<th>Fiscal Revenues per Capita</th>
<th>1981</th>
<th>1991</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-oil tax collection per capita</td>
<td>3.7</td>
<td>5.8</td>
<td></td>
</tr>
<tr>
<td>Oil tax collection per capita</td>
<td>9.0</td>
<td>7.3</td>
<td></td>
</tr>
</tbody>
</table>

Table 4
Principal Components of Public Sector Fiscal Accounts, 1988–92
Percent of GDP

<table>
<thead>
<tr>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Ordinary revenues</td>
<td>24.4</td>
<td>30.4</td>
<td>34.0</td>
<td>34.0</td>
<td>26.5</td>
</tr>
<tr>
<td>PDVSA surplus</td>
<td>11.4</td>
<td>20.5</td>
<td>25.9</td>
<td>24.5</td>
<td>17.6</td>
</tr>
<tr>
<td>Other SOE surplus</td>
<td>2.5</td>
<td>3.0</td>
<td>1.9</td>
<td>2.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Taxes</td>
<td>8.6</td>
<td>5.5</td>
<td>4.9</td>
<td>6.8</td>
<td>7.8</td>
</tr>
<tr>
<td>Ordinary expenditures</td>
<td>20.1</td>
<td>20.3</td>
<td>20.6</td>
<td>20.2</td>
<td>18.5</td>
</tr>
<tr>
<td>Wages</td>
<td>5.1</td>
<td>4.6</td>
<td>4.4</td>
<td>4.8</td>
<td>5.0</td>
</tr>
<tr>
<td>Goods and services</td>
<td>1.3</td>
<td>1.1</td>
<td>1.3</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Interest of external debt</td>
<td>2.6</td>
<td>4.7</td>
<td>4.0</td>
<td>3.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Transfers</td>
<td>6.2</td>
<td>6.7</td>
<td>7.4</td>
<td>7.0</td>
<td>6.9</td>
</tr>
<tr>
<td>Exchange losses</td>
<td>2.5</td>
<td>2.1</td>
<td>2.2</td>
<td>1.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>13.9</td>
<td>11.4</td>
<td>12.3</td>
<td>13.7</td>
<td>11.7</td>
</tr>
<tr>
<td>Deficit</td>
<td>-9.6</td>
<td>-1.4</td>
<td>1.0</td>
<td>-0.3</td>
<td>-4.5</td>
</tr>
</tbody>
</table>

Note: Figures on the fiscal deficit do not match exactly those shown in table 2 because several components, particularly extraordinary revenues, have been excluded here for the purpose of focusing the attention on the structural fiscal deficit.


Of 3 percent of GDP emerges, which was the combined result of an increase in public investment on the order of 2 percent of GDP and a 10 percent appreciation of the exchange rate. Table 4 allows for a better appreciation of the main components of fiscal accounts in the years under consideration; it focuses on the structural fiscal deficit by excluding extraordinary revenues.

It was unreasonable to expect that the rise in oil prices would continue, but it is not difficult to understand the temptation that windfall revenues represented for an administration hard-pressed to accommodate political demands in the midst of an adjustment process. In any case, top-level decisionmakers contend that the public expenditure levels of 1990 and 1991 were thought to be sustainable once the comprehensive tax reform initiated by the administration in 1990 passed Congress. In the short term, however, the decision to increase public expenditures in 1990 at the very least seems to imply that reducing inflation below the 30 percent annual threshold was not considered a top priority. Throughout the administration’s term, the combination of exchange liberalization and inflationary pressures on the fiscal side would increasingly be contained by monetary policy.17

Indeed, aware of the structural fiscal deficit, the Pérez administration attempted a reform of the tax regime, which included a reform of the income tax, a new valued added tax (VAT), and later a tax on assets, as well as substantial improvements in tax administration that were supposed to improve the efficiency of tax collection. For all practical purposes, these reforms remained to be enacted at the abrupt end of the Pérez administration in May 1993—a contrast to the effectiveness that the reform program exhibited in almost all other sectors. The...
dynamics of fiscal policy and tax reform would eventually become one of the most interesting aspects of the political economy of adjustment in Venezuela.

Tax reform is generally believed to be one of the most difficult reforms in almost any polity, because it relates to the deepest layers of governance in a society. On the one hand, what are the members of a society willing to contribute to finance governmental activities and what do they consider the proper level of such activities; on the other hand, what is the distribution of the burden of taxation among significant social groups? Large socioeconomic conflicts are built and dividing lines develop in almost every society in keeping with the preferences and willingness to pay of the different groups. In addition to this, experience with the conduct of economic policy in many countries in Latin America clearly teaches that populist economic policies are intrinsically linked to lack of appreciation of the consequences of deficit financing (Dornbush and Edwards 1991). As a consequence, successful tax reform is believed to be one of the distinctive signals of the achievement of long-term stabilization, or of long-term success in the adjustment response.

In Venezuela, still another element has to be included in the analysis of the issue. Historically, oil taxes have relieved individuals and firms of significant contributions to the financing of governmental activities, simultaneously creating a preference for high levels of public expenditure and a very low willingness to pay for publicly produced goods and services, either in the form of public sector prices and fees or in the form of general taxation. This adds to the difficulty of any major tax reform, because every rationalization of tax structure or administration runs against beliefs deeply ingrained in the political and economic culture. This difficulty was reinforced in 1990 and 1991, when both Congress and the executive were unable to avoid the impression that tax reform was not a priority—or not necessary at all—given the favorable developments in the international oil market.

Taking all these unfavorable factors into account, it is easy to understand why, by the time Pérez was forced from power, not a single tax reform had been approved by the Congress. It is instructive to take a closer look at some of the specifics of such a failure to reform the tax system. In the case of the income tax, in 1990 the administration sent Congress a bill that proposed a reduction in marginal tax rates, but compensated for this with the elimination or reduction of a series of loopholes that benefited the highest income groups. With this kind of proposal, the executive sought to both increase collections and to make tax administration easier and less demanding in personnel and red tape. Interestingly enough, Congress passed the reform of the income tax law, keeping the lower rates but increasing instead of reducing loopholes, with the net result that tax collections were bound to be lower and more difficult to administer. One of the most interesting aspects of this reform failure is that it cannot be attributed to the regressive redistributional consequences of the initiative; the passage of the original plan would have caused an increase only in taxes paid by the highest income groups. The upper-middle-class lobby proved powerful enough to block the provisions in the law that would have made Venezuela less of a tax haven for them.

18 For a very similar outcome of a tax reform process in a very different context that suggests the existence of a generalized problem of asymmetry of information among voters, organized interest groups, and political representatives, see Haftiz A. Pasha’s chapter on Pakistan in this volume.

19 Strictly speaking, there is no organized middle-class lobby in Venezuela. However, from the tax reform case and from other similar episodes it can be argued that a good share of members of Congress behave as if they were defending middle-class, or rather upper-middle-class, interests. This revealed preference for public policies that benefit the upper-middle-class at the expense of the majority of the population is what the text refers to, rather than to the existence of a clearly distinguishable interest group.
the earlier stage of debate in the Congress, and the tax on capital assets was introduced with delay.

Throughout this process, organized labor opposed tax reform—in spite of the progressive changes in income taxation and the creation of the tax on assets—for equity reasons, because the VAT was considered too regressive to be acceptable. Business associations opposed the VAT and the tax on assets because they thought they would discourage private economic activity. COPEI and AD considered the elimination of loopholes in the income tax to be unacceptable for the middle class and viewed the whole reform package as regressive. Behind all these arguments, however, it was clear that every group and party distrusted the ability of government to spend the newly increased fiscal revenues efficiently, and even distrusted the government’s need to improve its fiscal stance through a comprehensive overhaul of the tax system. The mentality of an oil-rich country was alive and strong (Rodríguez 1993); it did not matter that this was totally contrary to the difficult economic realities the country was facing, as table 4 illustrates.

All these events emphasize that even though the administration was able to move forward very fast on many fronts, progress can be attributed at least in part to the extensive powers of the presidency and the executive. In the case of reforms that had to pass Congress, progress in reforming the public sector or the economy was either much slower or nonexistent. This, in turn, is an indication of the very weak organized political support that “The Great Turnaround” was able to count on, since no political party, including AD, actively shared or supported the reform agenda. At the same time, the failed tax reform provides still another instance of a missed opportunity to show the country that there was a principle of fairness and equity behind the reform process, because the progressive nature of several of the tax reform proposals was never made known to the public to a significant extent.

Unraveling Political Stability: Antiadjustment’s Political Entrepreneurs and the Triggering Effect of a Coup d’État

Lack of organized political support for the structural reform program was coupled with widespread, but similarly unorganized, opposition from 1989 to 1991. Public sector unions represented a significant roadblock in the restructuring or privatization of several public agencies, and they had to be generously compensated to move forward with reform. The many businessmen who had lost privileges or preferential treatment by the state represented a less vocal and effective source of opposition than initially expected by reformers. The media were generally hostile, reflecting in part the widespread unpopularity of the adjustment measures. Prevention of further impoverishment and very high inflation never earned even minimal sympathy for the administration or its policies, probably because the Venezuelan population has never experienced very high or hyperinflation, which made it particularly difficult for the administration to argue in favor of policies that had prevented this unknown evil. The party in government, AD, took every opportunity to distance itself from policies they did not consider their own, having been conceived and implemented by a technocratic team alien to the party and incompatible with the party’s natural inclinations in economic policy. All this produced congressional support that was, at best, reluc-
Nevertheless, opposition to reforms remained diffuse for three years, and there was no other economic program that could be offered to the public as an alternative to the administration’s. This lack diminished the public appeal of the opposition for some time.

The president did not seem to have many places to go for support. The vision of an open and competitive economy resting on a vigorous and export-oriented private sector, with a government concentrated in regulatory and distributive activities, was not actively supported by any organized political force. It is hardly surprising that the president compromised with AD by reserving several important positions in the administration for party loyalists in exchange for what little support the party was willing to provide. This, in turn, would create severe difficulties for those pushing reforms ahead; for many it became hard to believe that the new policies were really that new and different, given that the highest levels of government were filled with people who not only did not share the president’s commitment to reform, but also were tainted by past allegations of corruption or clumsiness in the exercise of public responsibilities.

The relative weakness of the administration’s political position is stressed by the episode of the congressional passage of the new labor law in 1989. Under the sponsorship of former President Rafael Caldera, a new labor law was making its way through Congress when the new administration took over. Shortly after inauguration, the time had come to vote for the final passage of the bill, but the new law was completely opposed to market liberalization in both letter and spirit. It imposed stiff conditions for the hiring, compensation, and dismissal of personnel in every firm and organization in the country. Significantly enough, all political parties voted for the passage of the bill and the president did not veto it, apparently anticipating that with overwhelming support for the initiative in Congress, his veto would easily be overridden, leaving behind a bitter political battle (Naim 1993).

Yet opposition to reforms could not coalesce for three years, enough time for substantial progress in structural reforms. On February 4, 1992, a failed coup d’état would prove to be the signal for the many little and silent grievances against the administration and its policies to become one large and loud protest movement that would end up unseating Carlos Andrés Pérez before the end of the legally mandated five-year term. It goes beyond the scope of this chapter to present a detailed account of the failed coup, but it is indispensable to understand its role in stopping the reform process, crippling governance capacity, and creating the conditions for the reversal of major reforms.

By late 1992 the opposition to the Pérez administration had become a movement in search of a leader. The payoff for a potential political entrepreneur willing and able to identify himself

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20 The economic team spent considerable time and effort trying to build communication channels and understanding between the party leadership and the cabinet. Thus, they would often attend party meetings, where they would present the new policies and their justification. According to their testimony and the actual outcome of such efforts, it seems that they were not particularly successful.

21 COPEI, the largest opposition party, had included some of the elements of reform in its presidential platform, and its support was important to the passage of several reforms that required congressional action, such as the reform in the consumer protection law and the antimonopoly and antidumping legislation. The party, and particularly its leader, Eduardo Fernández, would become one of the few supportive forces of the administration after the failed coup in February 1992. Yet COPEI did not openly support the general vision behind the reforms and eventually contributed to block important initiatives such as tax reform, as has already been cited.

22 Probably the most important case in this regard is the one of control over the CVG (Corporación Venezolana de Guayana). This public corporation runs the heavy industries (steel and aluminum) created in the 1970s and constitutes one of the most significant contributors to the structural fiscal deficit. This was an obvious area of reform—privatization or restructuring—that the administration never tackled in a significant manner, leaving it in the hands of well-known public sector managers linked to AD.
with widespread discontent—widespread not only among the poor, but also among the privileged business and political sectors that had lost state support and subsidies—was potentially very large. The coup attempt, under the leadership of four middle-range officers of the army, according to their own account, had been considered and planned for at least a decade, so it could hardly have had much to do with the specific policies of the previous three years. It was finally launched in February 1992, and was prompted by two factors: the favorable political conditions and the achievement of positions of command important enough by those planning the attempt to make the coup possible.

Once the coup failed, its leader became a folk hero, thanks to the clumsy management of communications the day after the coup that allowed the chief rebel, Commander Chávez, to deliver a live, televised speech to the nation. In addition, in what would prove to be even more damaging for the reform process, Rafael Caldera also delivered a nationally broadcast speech. After briefly condemning the violent actions of the rebels, he proceeded to a thorough justification of their motives and a frontal attack on privatization, liberalization, and the other economic reforms of the Pérez administration, blaming them for an economic crisis that did not exist at the time and for jeopardizing democratic stability. These incidents would identify for Venezuelans the two leaders of the opposition in the years to come, and would signal that it was time to make explicit the grievances that so far had been kept hidden. The media would constitute the major channel for the dissemination of aggressive antireform positions: suddenly all the fears and uncertainties faced by Venezuelans after the attempted coup were blamed on economic reforms, even though the reforms were delivering all that reasonably could be expected from them in many areas.23

This episode is of particular interest because it demonstrates that—if the Venezuelan experience can be taken as a pattern—the generalized opposition generated by an adjustment program would create favorable conditions for the emergence of political entrepreneurs of anti-adjustment, and that the emergence of such entrepreneurs would depend upon the occurrence of an event that allows for the transformation of latent opposition into active and explicit opposition.24 The implication for the Venezuelan process is that, even if the actual occurrence of the coup d'etat can be considered an event exogenous to the implementation of the adjustment program, this program no doubt created favorable conditions for the magnification of the impact of such a political event. On balance, the event almost totally impaired governance capacity and was the beginning of the reversal of economic reform.

After the coup attempt and the ensuing speeches, the administration became even weaker politically. Important policies were put on hold—the gradual increase in gasoline prices, for instance—and those that continued, such as privatization, did so at a much slower pace. Several crucial economic ministers were removed from the cabinet and replaced, sometimes with people of the same orientation but less subject to recrimination for the design of the reform package. Nevertheless, a second coup attempt would

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23 It is worth noting that at no single moment of the bitter public opinion campaign against economic reform that followed the coup attempt was any alternative economic program explicitly proposed, or even sketched, by any of the antiadjustment political entrepreneurs.

24 It is reasonable to think that the coup attempt initiated a "revolutionary crisis" in the sense suggested by Kuran (1989, p. 53): a sudden and unanticipated enlargement of the opposition to a regime caused by an individual event that creates the incentives and opportunities for the abandonment by citizens of "falsified political preferences" and the explicit adoption of "hidden preferences." A crisis of this kind does not necessarily end in a government or regime change, but it makes that a very likely outcome, as the Venezuelan experience confirms.
follow in November amid generalized calls for the president’s resignation. Finally, in the first part of 1993, a much stronger and coherent opposition to reforms succeeded in targeting Carlos Andrés Pérez as the main and almost exclusive force responsible for the ills of the nation, and indicted him on charges of corruption, unseating the president and creating the need for a provisional administration that would hold office until February 1994, when a newly elected administration would be inaugurated following the elections in December.

The Reform Program Derailed: Is Reform Irreversible?

Ramón J. Velázquez: Reluctant Reform and the End of Coherence

One of the clearest indications of the strength of the economy under the Pérez administration is that in 1992, the year of the two coup attempts, GDP grew 7 percent and, apart from a $1 billion loss in foreign exchange reserves and the structural problems with the fiscal deficit, the bulk of stabilization achievements were preserved. Ramón J. Velázquez, the provisional president appointed by Congress after the indictment of Pérez, selected a new cabinet that looked very much like a compromise between those in favor of continuing economic reforms and those absolutely committed to stopping them. Some tinkering with protectionism and preferential treatment for the agricultural sector would take place, but without any clear shift in policy. It was the end of coherence and strong commitment to reform, yet in no way was this the end of reform itself.

On the fiscal side, there was substantial progress. The tax reform that had been stalled for years in the Congress was enacted in a curious way: the imminence of a huge fiscal deficit for 1994 made it imperative to enact some sort of tax reform in 1993. The Congress, still unwilling to take the political burden of passing new tax laws, passed an “enabling law” that would allow the president to legally change the tax system without congressional intervention. After some hesitation, Velázquez enacted the VAT and the tax on firms’ assets, completing the Pérez reform agenda in a quite unconventional way.

This was not, however, the last word in the story of tax reform. Enacted in the middle of the presidential campaign, the VAT became a major political issue. It was not only a new tax, unknown to Venezuelans, but it also presented serious implementation failures given the poor state of tax administration, where progress had been slow and difficult for reformers. The leading presidential candidate, Rafael Caldera, took a radical position against the VAT, promising to eliminate it as soon as he was elected, while the rest of candidates took a more nuanced position, criticizing the clumsy implementation but admitting the convenience of the tax. The highly charged political issue no doubt was influential in the final victory of Caldera on a radical antireform platform.

His administration thus far has been extremely coherent in signaling and maintaining a populist orientation, and in only nine months brought a substantial loss in the macroeconomic equilibriums restored by the adjustment response.

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25 The results in the December of 1993 presidential election gave the victory to Rafael Caldera, as a leader of a diverse coalition of small parties, with a little over 30 percent of the vote, followed by the candidates of AD; COPEI; and an emerging party, Causa R, every one of them with a little over 20 percent of the vote. This is quite an unusual result in Venezuelan elections, since it meant the breakdown of the electoral duopoly of AD and COPEI.
of 1989. The question is how far it would go down the path of reversing the structural reform program.

**Irreversibility of Reform?**

While the reform program was moving forward at full speed, it was often said that many of the specific reforms had the characteristic of irreversibility. Once completed, it would be impossible for a future opponent to shift back to the interventionist and protectionist pattern typical of Venezuela before 1989. The issue of the eventual irreversibility of reform can be tackled by looking at the specific devices built into the reform program to grant irreversibility and the degree to which they have been effective in achieving that goal.

Trade liberalization is supposed to be irrevers-ible because of the international commitments made by a country once the export-oriented and open economic model is defined. GATT and bilateral free trade agreements with different countries, particularly Colombia in the case of Venezuela, are good examples. In this respect, it is interesting to note how the political demand for protection rapidly increased in Venezuela as the new Caldera administration signaled in that direction. The Agricultural and Development Ministries have both complained that they have faced obstacles to the raising of tariffs because of such international commitments. Actually, new policies are being designed to increase protection through the use of nontariff restrictive practices that are both legally acceptable and economically and politically equivalent.

Closely related to trade liberalization is price deregulation. The new administration has used the reenactment of the price freeze and price control as the instrument of choice to fight growing inflationary pressures. It has undertaken initiatives to offer trade protection as an incentive for industrial sectors that agree to comply voluntarily with price regulations. As previously mentioned in the listing of structural reforms, the Institute for Consumer Protection was transformed into an Institute for Consumer Education, without power to enact or enforce price controls. The Caldera administration has initiated a legislative proposal to restore these powers.

Central Bank independence was another cherished policy signaling irreversibility. During the first three months of the new administration, the Central Bank maintained the crawling peg and high interest rate policy that it had implemented at the start of political instability in an effort to keep the exchange market free, while at the same time preventing massive capital flight. The new administration identified high interest rates as the source of poor economic performance and announced its intention to lower rates following a fixed schedule. This announcement triggered the resignation of the president of the Central Bank and an important flight to the dollar, which led to a devaluation of about 60 percent over a period of a few weeks and a massive loss of exchange reserves. The newly appointed directorate of the Central Bank is widely perceived as not having meaningful autonomy from the executive. In June of 1994, the administration decided to close the foreign exchange market in an attempt to stop the capital flight brought about by the loss of confidence in Central Bank autonomy and a series of government interventions in banking in the middle of a major financial crisis. After three weeks, the government decided to enact strict exchange controls at a fixed exchange rate, a policy presented

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26 Seabright (1994) has pointed out that the most important argument for Central Bank independence may not be that it prevents the executive from intervening in monetary policy, but that it increases the visibility of the occasions when it does so. The argument fits perfectly to the recent Venezuelan experience: the resignation of the president of the Central Bank in May, a signal generally read as the end of Central Bank independence, triggered the largest decrease in the value of Venezuelan foreign debt bonds in a single day to date; the fall was twice the size of the one produced by the first coup attempt in February of 1992 (Pablo 1994).
as temporary, but still in place as this chapter is being written.

Tax reform is another element to consider in examining the issue of irreversibility. As he promised during his campaign, Caldera eliminated the VAT. The fiscal deficit, however, made unavoidable the adoption of a whole new set of taxes, far less certain in their fiscal impact than the VAT, although clearly far more distorting. These included a tax on bank transactions, a sales tax on wholesale transactions, and a luxury tax. It is unclear at this point whether these tax reforms will produce a durable solution to the structural deficit in government revenues, although important steps have been taken in the reorganization of the agency in charge of tax collection. For the time being, the huge amounts spent to help ailing financial institutions have created a large source of monetary distortion in the economy and enlarged the dimensions of the fiscal deficit in a way that makes the management of fiscal policy increasingly difficult. Monthly inflation in the second half of 1994 was about 5 percent in spite of exchange and price controls, which suggests the possibility of very high inflation in the absence of a new stabilization program. If the international experience with adjustment is applicable here—given the high degree of political polarization in the country, at least since 1992, as measured by coup attempts, administration changes, drastic shifts in policy, and lack of legitimacy of major political institutions—the chance of an effective handling of fiscal policy in the short term seems slim at best (Edwards 1994).

Privatization was halted by a decision of the interim president, and so far the new administration has given extremely mixed signals concerning its willingness to push forward a privatization program, even if hard-pressed by a large fiscal deficit. The most important cases of privatizations completed under the Pérez administration have not been openly challenged, but the attitude toward the new private owners has been hostile. All in all, the economic and contractual characteristics of privatization seem to have made it the most—and probably one of the few—irreversible policies undertaken by the reformist administration.

So far, the Caldera administration has earned a reputation for a lack of coherence and noncompliance with former promises in economic policy. It has lost the confidence of the international investment community: Venezuelan bond ratings are around 20 percentage points less than they were in 1991; its rating by international country-risk-assessment agencies has worsened significantly; and the country risk has been estimated in the third quarter of 1994 at around 12 percent (Pablo 1994). At the same time, the Caldera government remained highly popular in public opinion polls during its first year; this great popularity can be viewed as its main source of strength. It is indeed a paradox of the politics of the adjustment process in Venezuela that an administration that had strong credibility with investors had no credibility with the Venezuelan citizens (the Pérez case), yet the administration that has achieved and maintained popular confidence has managed to lose the investors’ confidence.

The balance, if any can be established in such a short period of time, is that reforms are indeed reversible. With the partial exception of privatization, reform will be reversed, resurrecting large distortions and inefficiencies throughout the economy and undermining its competitive potential.
Adjustment without Vision? How an Adjustment Process without Political Support Can Go Only So Far

In an international conference that took place at the beginning of the adjustment process in Venezuela, Ricardo Hausmann, later to become the planning minister of the last year of the Pérez administration, said that the success of the adjustment response and structural reform in Venezuela would depend upon its ability to deliver good results rapidly enough to gain the social and political support that, he recognized, was critically scarce at the time of the initiation of reforms (Williamson 1990). Unfortunately, in light of the many benefits that the reform program could have offered Venezuelan society, time would prove that statement to be wrong. The economic reform program did not fail to deliver. It can hardly be denied that the short-term adjustment response was a striking success, measured either in stabilization or in the design and launching of a comprehensive structural reform program. Yet it is easy to see, judging from the Venezuelan experience, that such a success was not enough to turn the economy and the country around in a more permanent way. Economic success did not translate into political support.

This point deserves some elaboration. It can be argued that the bad economic performance of 1989, a result of the devaluation and recession induced by the implementation of the adjustment program, was the original source of widespread opposition to the program. That might be the case. Several elements introduced in this chapter, however, may lead one to question such a conclusion. It can be asserted that, whatever the misery of 1989, things would have been worse without adjustment. Even if this view is correct, as I think it is, prevention of greater difficulty had a very low potential to earn political support for the program, since counterfactuals rarely, if ever, earn political support. But there is more to it than this: simply put, the relationship between economic performance and political support is far from direct.

This is perhaps one of the most central issues of this chapter: if we say that opposition to the program came from the undeniably bad economic performance of 1989, then why did the extraordinarily good performance of the in economy in 1990, 1991, and 1992 not garner generalized and strong support? To address this question, an ad hoc explanation of the asymmetry in the relationship between performance and support is needed: bad performance produces opposition, but good performance does not translate into support, at least in the short run. Again, this may very well be, but then the general point is confirmed: the relationship is far from simple and direct.

Still, some would say that the urban riots of February 1989 are proof that the effects of the adjustment package caused widespread resentment and active opposition to reform, but then we encounter a clear logical inconsistency. The riots took place before the package had been implemented, and it is generally believed that it is difficult for a consequence to take precedence over the cause. Once more, a plausible answer to this objection would be that it is not actual performance that causes a particular response to reform attempts, but the expectations and perceptions that accompany the adjustment process. Then again, the model that may eventually succeed in accounting for the relationship between economic performance and social and political response is likely to be complex, and it will by no means stipulate a direct and short-term relationship between good performance and strong or generalized support for reform attempts, or for the administrations that implement them.

Thus, if the Venezuelan case is to provide any guidance, there seems to be no substitute for a well-articulated and clearly communicated vision.
that can be shared by substantial social and political groups, creating the basis for strong and coherent political support for promarket reforms. The Pérez administration attempted a radical change in the basic orientation of the economy and the state that had scant organized political support. So meager was the support that one must admire how far the reform program went in the three years of its forceful application. The projected changes had coherence, were designed with a high degree of technical competence, and were attuned to international trends, yet lacked almost any other component of an effective vision. In contrast, the reform process had to take into account a number of severe initial political constraints, essentially those of the legitimacy crisis that political parties and all major political institutions were experiencing in the years immediately preceding the launching of adjustment, but also included the widespread decay in the capabilities of public bureaucracy and the lack of market-oriented economic culture in Venezuela after decades of protectionism and interventionism.

Given such constraints, governance capacity was critical in advancing reform, but it was reduced to presidential popularity and constitutional power, two sources that proved to be insufficient to sustain the reformist drive, and particularly to ensure its permanence. The very fact that allegations of presidential corruption were generally believed as credible—regardless of their authenticity, yet to be established by the courts—reveals a critical weakness in the leadership capabilities of an administration that could not possibly have succeeded without conveying a strong sense of authenticity and fairness in sacrifice to a population that had indeed contributed with substantial welfare losses to the advancement of adjustment and structural reform. Thus, there was no ability to convey fairness in the sacrifices needed or to alert the population to the efforts made to compensate the social costs of adjustment or to build an explicit connection between the reform program and wider national values and goals. Under these conditions, it was difficult to communicate the importance of the program or to energize the population in favor of reforms, which would have solved, at least partially, the collective action problems attached to any large project of social change.

It has become common to think about the political economy of adjustment processes in terms of compensation: gaining support and offsetting opposition requires the identification of those in need of compensation and the decisions concerning when, how, and how much to compensate them (Seabright 1994). Yet another interesting aspect of the Venezuelan case is that there was no shortage of compensating initiatives: the program to fight poverty was well-financed and effectively implemented during most of the Pérez administration. It was directed at the poorest segments of the population, those presumably most seriously affected by adjustment, and its main failure was the delay in its start, rather than the amount of resources made available. But there was a set of other compensation mechanisms and initiatives put in place at different moments of the reform process: the middle class received the benefits of a law substantially subsidizing mortgage payments soon after interest rate liberalization in 1989; public sector workers affected by the restructuring of their agencies or enterprises were generously compensated, far beyond their legal claims in the cases of the agencies in charge of ports, water supply, and others. Businessmen received a large devaluation that seems to have been sufficient to compensate for the elimination or reduction of barriers to imports.

No substantial political benefits in acceptance or support for reform were realized from the significant investment of resources in these compensation initiatives, suggesting that uncertainty about the intent and ability to compensate may not be dissipated exclusively through the actual implementation of specific elements of compensation. This, in turn, leads to the conclusion that an active effort of coalition building and the elaboration of an appropriate political discourse are
required components of compensation schemes that will actually earn support for reform programs, or at least reduce opposition to them. Once more, perceptions and expectations should play a key role in any explanatory model of similar processes.

It is usually argued that opposition to reform can be adequately explained by looking at interest group dynamics. Because widespread rent-seeking and capture are the most common starting points of reform in developing countries, it is often natural to think about resistance to adjustment, and especially structural reform, through the strategies put in place by interest groups to undermine the reformist drive. There was much of this dynamic in the Venezuelan experience: several specific features of the very design of the reform strategy by the president can be explained as a clear attempt at avoiding head-on conflicts with powerful interest groups, as described above. Yet it is also clear in the Venezuelan experience that this is, at most, just a part of the story. To begin with, potentially powerful interest groups were not always a source of direct opposition to reform, the best example being the private sector after the rapid reduction in trade protection. But, more fundamentally, the history of the sudden consolidation of a strong antiadjustment coalition after the attempted coup of February of 1992 can only be explained by looking at the active role played by political entrepreneurs and the incentives they face in an adjustment process. No single party, interest group, or faction was responsible for it, yet the political defeat of those advancing structural reforms took place under the leadership of political entrepreneurs able and willing to become the public expression of the many minor sentiments created by economic reforms, if that would prove to be an effective path to public office.27

In the explanation of the end result of the Venezuelan reform process, it is very difficult to disentangle the role of initial constraints—generally speaking, the weak governance capacity and what has been referred to as the legitimacy crisis of democratic institutions in the country—from the weight of actual mistakes made by reformers, above all the failure in formulating an effective vision, and the active role played by antiadjustment political entrepreneurs. All three played key roles in the way things turned out in Venezuela, and this uncompromising if somewhat disappointing statement should be enough for the purposes of a country study, such as the one presented here. Such a conclusion, of course, is blatantly insufficient from a more general point of view—when looking at other reform attempts in developing countries, and establishing comparisons, the goal should be to enhance our understanding of how these elements interact to produce given instances of success or failure in economic reform.

There is every indication that some of the achievements of the structural reform process can and will be reversed by the Caldera administration, stressing the short-lived nature of sudden shifts in governmental policy that are not accompanied by a solid political base and a well-articulated vision. Thus, the Venezuelan case seems to suggest that effective visions are not indispensable for short-term successful adjustment responses, but that they are indeed of great importance to the sustainability of reforms, and thus in determining the possibility of permanently enhancing governance capacity in developing countries.

27 The general point here is in line with the following comments by Bates (1990), when evaluating the contribution of interest group and collective choice theory to the understanding of the political economy of developing countries: “We must look to the political incentives that shape politicians' economic choices; for, by this analysis, politicians are not perfect agents of economic interests but rather have distinctive political incentives of their own. We must therefore understand the nature of the political problems politicians try to solve when making economic policy. We must also look at the ideologies that motivate their interventions. If politicians do take the initiative, we must turn our attention from the economic forces that demand political intervention to the political forces that supply it” (p. 44).
Bibliography


Vision, Policy, and Governance in Malaysia

Jomo K.S., Khoo Boo Teik, and Chang Yii Tan

For much of the thirty-eight years since it gained independence from British colonial rule in 1957, Malaysia was regarded as a moderately successful, middle-income, commodity-producing, and net oil-exporting developing country. But the last eight years of uninterrupted, high, export-oriented, and manufacturing-led economic growth, beginning in 1987 and averaging over 8 percent annually, has transformed Malaysia into a second-tier, newly industrializing country. Now ranked nineteenth among the world’s industrialized nations, Malaysia has arguably become East Asia’s “fifth tiger,” after the Republic of Korea, Taiwan (China), Hong Kong, and Singapore.

There are several remarkable features in this economic transformation. First, it seems to have started in the late 1980s, in the wake of Malaysia’s severe economic recession of 1985–86 and some of its most intractable political crises. Second, the transformation is associated with the privatization and economic liberalization policy, launched by Prime Minister Datuk Seri Dr. Mahathir Mohamad, previously regarded as a staunch ideologue of state economic intervention. Third, it appears to have been scripted to follow Mahathir’s post-1990 National Development Policy, more popularly known as “Vision 2020,” which captures Mahathir’s hope of propelling Malaysia into the ranks of the developed countries by the year 2020. Fourth, the economic transformation features a regime “rolling back the frontiers of the state,” in a Malaysian variation of the “strong state, free economy” model that was most emphatically advocated by Margaret Thatcher for the United Kingdom in the 1980s. In short, Malaysia’s progress since the late 1980s appears to have been a composite of farsighted vision, firm economic adjustment, and high governance capacity.

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Governance Capacity and Vision

How might this Malaysian experience of economic recovery and transformation illuminate the junctures between the sociopolitical vision of a leader, the governance capacity of a state or regime, and the outcome of economic adjustment under stressful circumstances? It is the objective of this chapter to provide some answers to this fundamental question.

We might first delineate how the concept of governance capacity is used in this chapter, albeit without engaging in a theoretical exegesis of the concept. In principle, governance capacity denotes the ability of a state or regime to govern based on a claim to legitimate authority, which is acknowledged and accepted by the governed. Governance capacity may or may not be enhanced by the coercive (even repressive) capacity that all states and regimes retain, and the former should be differentiated from the latter. In practical terms, governance capacity refers to the ability of a state or regime to set, shape, offer, gain acceptance for, and implement its agendas—the social, economic, and political agendas, subject to variations or changes depending on circumstances that cannot be determined in advance.

It is assumed that social groups, vested interests, and political forces will exhibit a variety of responses to these agendas, including support, indifference, criticism, and rejection. Some of these forces may well contest the state or regime agendas with their own alternatives. Thus, a regime may be said to have a high governance capacity if it can consistently gain a sufficiently broad acceptance of its agendas in competition with alternative agendas. In multiethnic societies with class divisions cutting across the ethnic groups (such as Malaysia), a regime’s governance capacity probably hinges on its ability to promote its agendas as national rather than merely sectarian, or to frame its public discourses as universalizing instead of particularistic. This applies even if the agendas and discourses address limited ends or narrow interests (as, indeed, they frequently do).

A leader’s “vision” may mean quite different things to different social classes and ethnic communities, reflecting competing, if not antagonistic, claims. Thus, acceptance of a leader’s vision may be grudging or forthcoming depending on whether it can be shared rather than imposed. This may be critical when a regime undertakes a stringent program of economic adjustment, and can only promise the populace, or certain segments of it, future gain in exchange for immediate pain.

But governance capacity is not merely a function of persuasion and discourse. It is grounded in the performance of a state or regime, or its success or failure in carrying out policies, programs, and projects it is committed to implement. If an overarching policy with clearly established objectives and targets exists (such as Malaysia’s New Economic Policy), a regime’s governance capacity will be enhanced by their attainment; conversely, it will be impaired by inadequate performance (whatever its root causes may be). Similarly, vision endures and captivates to the degree that experience suggests that it works.

On the basis of the above understanding of governance capacity and vision, this chapter provides a comparative study of two Malaysian experiences with economic adjustment. The first involves the New Economic Policy (NEP), which was promulgated in 1970, with planned implementation to extend until 1990. The second is based on Mahathir’s policy initiatives and management of the economy, especially after 1986. Although Mahathir’s premiership began in 1981, and several of his major policies were attempted between 1981 and 1985, this chapter focuses on Mahathir’s policy responses to the Malaysian recession of 1985–86, later consolidated after 1990,
particularly in the form of Vision 2020. To set the stage for such a comparative study, the chapter provides an overview of Malaysian society and political history and discusses the failure of the first postcolonial regime to solve critical problems of political economy in Malaysia’s “race and class” society.

This chapter seeks to demonstrate that while vision and governance capacity facilitate successful economic adjustment, their roles are neither fixed a priori nor unchanging in relation to economic constraints and political realities. It cautions against any mechanistic assumption that vision supplies a blueprint for adjustment, while governance ensures its implementation. It is hoped that the chapter will illustrate that the Malaysian experience with NEP and Mahathir’s Vision 2020 raises the general propositions that vision can be an outcome of economic failure as well as a precondition for successful adjustment, and high governance capacity facilitates, but is also constrained by, adjustment performance.

Ethnicity and Class

To help us understand and analyze these issues, it is useful to begin with a quick overview of Malaysian society and politics. Geographically, the country is made up of two major entities. There is Peninsular Malaysia—that is, the Malay Peninsula—which is contiguous with the land mass of Thailand to the north, and linked by a causeway to the island-state of Singapore to the south. The other region of Malaysia consists of Sabah and Sarawak on the northwestern flank of Borneo Island, the rest of Borneo being the small state of Brunei, and Indonesian Kalimantan. This region was once referred to as East Malaysia, but the name has been dropped from official use.

The Federation of Malaysia has a total of thirteen states, with eleven states in Peninsular Malaysia, which made up the Federation of Malaya until 1963. The Federation of Malaya merged with Sabah, Sarawak, and Singapore in 1963 to form Malaysia. Singapore, however, separated from Malaysia in 1965 as a result of irreconcilable differences between the federal government of Malaysia and the state government of Singapore.

The population of Malaysia (excluding Singapore) was approximately 8.9 million in 1963, and has since grown to almost 20 million today. The population is composed of many different ethnic communities. Official classification divides the population between the Bumiputera, or indigenous, people of Malaysia and the non-Bumiputera, or nonindigenous people. By this classification, the Bumiputera consists largely of the Malays and the aboriginal groups in Peninsular Malaysia and the various “natives” of Sabah and Sarawak. The Sabah and Sarawak Bumiputera include numerous groups, such as the Kadazan, Murut, and Bajau of Sabah and the Iban, Melanau, Bidaiyu, Kayan, Kenyah, Kelabit, Berawan, and Penan of Sarawak. The non-Bumiputera category chiefly refers to the Chinese and Indians, whose presence in Malaysia became significant with the waves of immigration from China and India, which were tolerated or encouraged by the British colonial administration, especially in the nineteenth and early twentieth centuries.

In recent years there has been an official tendency to differentiate the population along religious lines, the most important dividing line being that between Muslims and non-Muslims. Without exception, the Malays, including those of Sabah and Sarawak, are Muslims. There are sizable numbers of indigenous non-Malay Muslims in Sabah and Sarawak, as well as Indian
Muslims in Peninsular Malaysia, and a small number of Muslim converts of other ethnic backgrounds. Other Malaysians are classified or regard themselves as non-Muslims. According to the Constitution, Islam is the official religion of the country, but there is freedom of worship.

These major ethnic and religious differentiations do not exhaust the cultural complexity and diversity of Malaysian society. They do, however, crudely reflect the reality of Malaysia’s plural society, a characterization of Malaysian society that has been compelling for many observers because Malaysian social and political life appears to be overwhelmingly organized around this plural society and its trends of fluctuating interethnic competition, compromise, and conflict. Political parties are mainly ethnically based, all kinds of issues are readily “communalized,” and political coalitions represent attempts at interethnic compromise. National economic, educational, and cultural policies, to take prominent examples, either explicitly or subtly discriminate on the basis of ethnic and religious differentiation.

Nevertheless, Malaysian social and political life is not—and historically, never was—exclusively determined by the realities of its plural society, as many analysts, viewing Malaysian society from this ethnic perspective, tend to insist. They overlook other features of postcolonial Malaysian society, which has deep class cleavages, for example, that are no less significant than the ethnic distinctions.

From the immediate post–World War II years until the late 1960s, the most important (Peninsular) Malaysian class and occupational divisions coincided with the main ethnic divisions. The Malay aristocracy was relatively small but influential, with members groomed by British colonialism to help run the state apparatus. The “commanding heights” of the Malaysian economy, which were unmistakably dominated by foreign nationals during colonial times, remained under foreign control after Malaysia’s experience of political decolonization without economic nationalization. But this foreign presence was arguably less visible than that of the ubiquitous local Chinese capitalists. Some of the latter had comprador origins in colonial times, and most continued to be primarily engaged in commercial and financial pursuits, rather than industry.

The working class was mainly composed of an urban, Chinese component, based in services and industry, and an Indian component, primarily engaged in public works and services. Among agriculturalists there was a sizable group of Chinese squatter-farmers, but the Malay peasantry was by far the single largest component. Again, this summary of the structure of newly independent Malaysia does not reflect all the complexities of its class divisions. It merely seeks to show that postcolonial Malaysian society had an ethnic division of labor that reflected the classic, colonially bred pattern that was found in several other former British colonies.

Hence, before the 1970s, the class conflicts and ethnic tensions that arose from Malaysia’s pluralistic society and ethnic division of labor combined to produce the major political crises of the Malayan and Malaysian states. Between 1948 and 1960, the state fought an insurrection led by the Communist Party of Malaya, composed mainly of Chinese communists, left-wing Malay nationalists, former wartime partisans, radical sections of the Chinese and Indian working class, and Chinese squatter-farmers. The insurrection was virtually defeated by a counter-insurgency program, officially called the “Emergency.”

In the process of winning this victory, the state extended its writ in several ways. Its military was bolstered by the creation of a Malay “ethnic soldier” (Enloe 1980). The Special Branch of its police was strengthened by the recruitment of anti-Communist Chinese officers (Zakaria 1978). The colonial state’s bureaucracy was reestablished and gradually Malayанизed. Perhaps the colonial state’s coercive capacity was best illustrated by its forcible resettlement of about half a
million (mostly Chinese) squatter-farmers in “new villages” (Loh 1988), the prototype for Vietnam’s “strategic hamlets.”

With the Emergency, the colonial state gained time to come to terms with a conservative Malayan nationalist movement led by Malay aristocrats. It gained space for a multiethnic elite, led by Malay aristocrats and Chinese capitalists, to experiment with coalition politics in preparation for a new polity based on the electoral franchise and party politics. By 1957, the Alliance, a tripartite coalition of the United Malays National Organization (UMNO), the Malayan Chinese Association (MCA), and the Malayan Indian Congress (MIC), had been formed to govern a newly independent Malaya. The Alliance governed Malaya, and then Malaysia, for the next twelve years.

**Political Economy under the Alliance, 1957–69**

During its tenure, the Alliance continued the colonial repression and police harassment of its class opponents, this time the parliamentary left, which included the Socialist Front, made up of a Chinese-majority Labour Party and the Malay-majority Partai Rakyat Malaya (PRM, or Malayan People’s Party). But the Alliance did have wide electoral support. It won the 1959 and 1964 general elections, each time retaining a two-thirds majority in Parliament. (It also won the 1969 election but came to grief in the process, as will be discussed below.)

Its success rested on at least two major points relevant to this discussion. First, as the “party of independence,” it had inherited the mantle of Malayan nationalism, which the radical anticolonialists forfeited in defeat. The mantle conferred a mandate to govern. Second, the Alliance’s so-called formula of balancing Malay special rights with non-Malay citizenship and improving the Malays’ economic position, while protecting the non-Malays’ economic position, appeared to embody the kind of interethnic compromise and cooperation that a newly independent, multiethnic Malaya required. To that end, the Alliance consistently occupied the middle ground, offering and conducting itself as a coalition that had won support from all ethnic groups, unlike the “extremist” or “chauvinistic” opposition parties that were rather more captive to single, ethnic constituencies. In that sense, not only had the Alliance inherited a sophisticated military-police-bureaucratic apparatus left behind by the British, but it had also built up its own considerable governance capacity.

The Alliance’s governance capacity grew increasingly tenuous as the 1960s wore on. The anticolonial and class struggle of the Emergency was followed by the ethnic recriminations that dominated Malaysian politics in the 1960s. Disenchantment with the Alliance grew with increasing unemployment, worsening income inequalities, and the regime’s inability to stem increasing ethnic polarization. The poor and marginalized Malay peasantry expressed its dissatisfaction through the religious-nationalist idiom of Parti Islam SeMalaysia (PAS, or Pan-Malaysian Islamic Party) (Kessler 1978). The Malay intelligentsia, middle class, and bureaucrats—led by some of the ruling UMNO’s own politicians—were impatient with the Alliance’s laissez faire, which left them commercially and financially well behind their Chinese counterparts, and Chinese capital in particular. Middle-class and working-class non-Malays considered themselves disadvantaged by the constitutional provision of certain “special rights” for the Malays. Those special rights entrenched the position of the Malay rulers, the Malay language as the national language, a preferential quota for Malay recruitment into the
civil service, and, most important, enhanced state economic assistance for Malays, all in support of their special position within the country. Between a Malay anxiety to protect their special position from non-Malay encroachment and a non-Malay insistence on a "Malaysian Malaysia," a chasm of interethnic recrimination was created. The politics of the 1960s were increasingly characterized by interethnic accusations and chauvinistic brinkmanship, most of all during the campaign for the May 1969 general election.

The Alliance regime was committed to a policy of laissez faire, a pillar of the independence compromise struck among British colonialists, the Malay aristocracy, and the Chinese capitalists. This meant a mild strategy in developmental terms, perhaps matching Prime Minister Tunku Abdul Rahman's reputed moderation in politics. The state urged plantation-oriented agricultural diversification oriented toward exports in commodity production and industrialization through low-level import substitution. Neither threatened foreign capital or local businesses. Rural development was planned to provide basic infrastructure to rural residents and to raise their productivity and income without land reform; in this way, politically influential landed interests were not offended.

Under the circumstances, the Alliance's formula of leaving business very much to itself was disastrous in at least two major ways. First, it failed to meet the mass expectations of improvements in living conditions, expansion in economic opportunities, and greater scope for social mobility that were raised by decolonization in Malaysia, as they had been elsewhere. Those expectations were keenly felt among very broad sections of the Malaysian population when manufacturing employment and land development could not keep pace with the growth of the labor force in the 1960s. Second, while staying out of business seemed consistent with the "Alliance formula" and Tunku's vision of leaving "politics to the Malays" and "economics to the Chinese," the policy sowed the seeds of its own destruction, proving to be unsustainable in the long run (Jesudason 1989, pp. 47–75). A nascent Malay business class, a vocal Malay middle class, and a marginalized Malay peasantry could not accept "economics for the Chinese" (Mahathir 1970, p. 15), while a resentful non-Malay middle class and a repressed non-Malay working class rejected "politics for the Malays."

When the May 1969 elections were contested in this conjunction of ethnic and class disaffection, the Alliance's middle ground partially collapsed, as the Islamic PAS, the "Malaysian Malaysia" Democratic Action Party (DAP), and the social democratic Gerakan Rakyat Malaysia (Gerakan, or Malaysian People's Movement) made substantial electoral gains. UMNO lost eight of its fifty-nine parliamentary seats, while the MCA lost fourteen out of twenty-seven. The losses were insufficient to topple the Alliance, but enough to damage the "consociationalism" of its ethnic elites. Perhaps the overall result did not justify the desperate anger of UMNO's Malay supporters or the reckless exuberance of the non-Malay opposition parties' followers, but on May 13, only two days after the elections, Kuala Lumpur was engulfed by interethnic violence. The May 13 incident, Malaysia's crisis of decolonization, ended the Tunku regime. Using emergency powers, Deputy Prime Minister Tun Abdul Razak convened a National Operations Council (NOC) and became its director. While the new regime had token representation from the Chinese (MCA) and Indian (MIC) partners of the

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1 DAP, widely perceived as a Chinese party, advocated a 'Malaysian Malaysia' platform that opposed ethnic privileges. Since the 1970s, DAP has won most of the urban non-Malay parliamentary seats, making it the most important opposition party.

2 The most complete account of the May 1969 election and the ensuing violence, from a point of view sympathetic to the Alliance, was given by Von Vorys 1975.
Alliance, in reality, Razak; select UMNO leaders; and the chiefs of the Malay-dominated army, police, and bureaucracy ruled Malaysia, while the newly elected Parliament remained suspended.

**Economic Adjustment and State Intervention: NEP, 1970–81**

We need not rehash the many administrative details regarding NOC's bout of authoritarian but effective rule, which lasted until March 1971. But it is essential to note that NOC showed that the state's governance capacity was equal to the crisis (Von Vorys 1975). NOC was immediately able to confine the violence to Kuala Lumpur and to end it within a matter of weeks. Within months it had reestablished a semblance of normalcy in Kuala Lumpur and in the rest of the country. Within one and a half years it had restored parliamentary rule, albeit by strengthening the Sedition Act, which reduced the scope of parliamentary immunity debates on sensitive issues—constitutional provisions pertaining to the Malay rulers, Malay language, Malay special rights, and non-Malay citizenship.

More pertinently, within a year, the state was able to promulgate NEP. NEP's premises were that poverty, Malay resentment of interethnic income and wealth inequalities, and the ethnic division of labor lay at the heart of the mass dissatisfaction with the Tunku regime that exploded in May 1969. To overcome those problems, NEP had two objectives: "poverty eradication irrespective of race" and "restructuring to abolish the identification of race with economic functions." For poverty eradication, NEP's "Outline Perspective Plan 1970–90" proposed a decline in the poverty rate from 49 percent in Peninsular Malaysia in 1970 to 16 percent in 1990. Restructuring was intended to raise the Bumiputra share of corporate equity from 2.5 percent in 1970 to 30 percent in 1990. And in seeking to "eliminate the identification of race with economic function," NEP proposed a massive affirmative action program that would favor Bumiputera and limit non-Bumiputera access to tertiary education and civil service employment.

Malaysia's economic planning has traditionally been carried out on a five-year basis. Accordingly, NEP's implementation began with the first post-1969 plan, the Second Malaysia Plan, 1971–75. But the full elaboration of NEP also involved subsequent plan documents, up to the Fourth Malaysia Plan. In the process, NEP encompassed several major developments.

First, although restructuring had officially been promoted as an exercise to redress interethnic imbalances—principally by redistributing corporate wealth ownership as well as employment—it became, in practice, a huge social engineering project that altered the class structure of Malaysian society. It accomplished this primarily by sponsoring the rise of a Malay capitalist class, which has come to be known in recent years as the Bumiputra Commercial and Industrial Community (BCIC). NEP-sponsored Malay capitalists have variously been called statist capitalists, because of their bureaucratic associations and reliance on state power and patronage (Jomo 1988); distributional coalitions, for their involvement in powerful rent-seeking ensembles (Mehmet 1986); and ersatz capitalists, because of their orientation toward short-term accumulation rather than long-term industrial development (Yoshihara 1988).

Second, the state radically reversed the Alliance's policy of leaving economics to private capital. Laissez faire was replaced by growing state intervention in the economy. Allocations for public sector expenditure vastly increased during NEP years. Compared with the RM4.6 billion allocated under the pre-NEP First Malaysia Plan (1966–70),
the allocation for the first NEP five-year plan (the Second Malaysia Plan, 1971–75) was RM10.3 billion (Jomo 1990, p. 106, table 5.1). In the Third Malaysia Plan (1976–80) the allocation rose to RM31.1 billion, while in the Fourth Malaysia Plan (1981–85) the figure was RM48.9 billion (Jomo 1990, p. 106, table 5.1). Indeed, total public expenditure as a proportion of GNP rose from 28.7 percent in 1970 to 61.2 percent in 1982 (Mehmet 1986, p. 133, table 6.1).

The state also entered businesses in a large way, seeking to expand public sector ownership of corporate equity and to build up state-owned business enterprises. The state’s enlarged role in business spawned a proliferation of public enterprises. The number of public or state-owned enterprises grew from 22 in 1960, to 109 in 1970, to 656 in 1980, and to 1,014 in 1985. The early NEP period was the heyday of state agencies, banks, and funds that sought and held equity in trust for the Bumiputera. Some of the best known of these were Bank Bumiputra Berhad, PERNAS (Perbadanan Nasional, or National Corporation), PNB (Permo-dalan Nasional Berhad, or the National Equity Corporation), ASN (Amanah Saham Nasional), UDA (Urban Development Authority), MARA (Majlis Amanah Rakyat, or the indigenous People’s Council of Trust), and the SEDCs (state economic development corporations). Such a proliferation of public agencies required an expansion of public sector employment, which grew, excluding military and police personnel, from 139,476 employees in 1970 to 521,818 in 1983 (Mehmet 1986, p. 9, table 1.3).

Third, the state became a determined regulator of business, mostly local Chinese enterprises, although foreign companies operating in Malaysia were also affected. The state strengthened its regulatory powers through the Industrial Coordination Act (ICA) of 1975 and the establishment of the Foreign Investment Committee (FIC) to ensure compliance with NEP’s restructuring requirements. In practice, this meant a quota of at least 30 percent for Bumiputera equity participation and employment in companies covered by the ICA (Jesudason 1989, pp. 128-47). ICA, originally applicable to any manufacturing firm with RM100,000 or more in shareholder capital and employing at least twenty-five workers, was unpopular with non-Malay (including foreign) businesses. It was especially irksome to local Chinese businesses, which considered itself to be the ICA’s main target. The ICA gave the minister of trade and industry tremendous discretionary powers over licensing, ownership structure, ethnic employment, product distribution quotas, local content, and the pricing of products (Jesudason 1989).

Given the interethnic violence that prompted its response, the state was very careful in its ideological presentation of NEP. Razak, Tun Dr Ismail, Ghazali Shafie, and their colleagues, who crafted NEP, offered a vision of achieving interethnic economic parity in order to attain genuine national unity, which had eluded the Alliance.4

They justified NEP as a policy to correct the Malays’ historical “backwardness” in relation to the non-Malays. Restructuring, then, was unavoidable, and socially desirable and just, but they reassured the non-Malays that it would be carried out in an expanding economy so that there would be no sense of deprivation among the non-Malays. NEP’s restructuring actually targeted increases for both the Malay and non-Malay shares of corporate wealth—at the expense of the foreign share.

Was this a shared national vision rather than an imposed ethnic perspective? It would be unsatisfactory to give a categorical or static answer...

3 For a critical analysis of what Malay trusteeship involved, see Mehmet 1986 (pp. 6–11, 132–54).

4 In pursuit of national unity, NOC also proffered a national ideology, the Rukunegara, but it never quite caught the public imagination. It was the bread-and-butter NEP—and mostly restructuring—that has generated the fervor of both NEP supporters and detractors.
to the question. Inadequate as it may sound, the answer is: probably a little of both. In so far as a comprehensive response to a national tragedy tends to contain a shared or universalizing potential, most sections of the Malaysian nation (with differences, most certainly) could accept the rationale for NEP for national reconstruction. Therein lay NEP’s bonding, or shared, qualities. Whatever one’s notions of social justice or inter-ethnic relations, there was no mistaking that 13 May 1969 had brought Malaysian society to a watershed. Tunku, nominally still prime minister in 1969–70, had been sidelined while NOC ruled. The Alliance regime and what it stood for were things of the past, a reality capped by Tunku’s retirement in September 1970. Something akin to NEP in its capacity to redelineate the politico-economic parameters of Malaysian society would have had to be invented even if NEP had not been promulgated in 1970. NEP, when it came, had the advantage of being a visionary and comprehensive response to national trauma: it supplied a diagnosis, imposed a treatment, and specified a period of recovery.

But NEP’s discrimination also had to be imposed by law and administrative fiat, because its ideological justification remained flawed. At a general level, the Malays applauded restructuring as affirmative action, while the non-Malays tended to resent it as ethnic discrimination. At the level of party and coalition politics, only the UMNO politicians and Malay bureaucrats were really persuaded by NEP’s “national unity” rationale. Most would concede that NEP contributed to ethnic polarization in later years, but UMNO’s non-Malay political partners, who claimed to support NEP in principle, were also apt to complain about its overzealous implementation, leaving others to wonder about their commitment to NEP. In the sphere of commerce, Malay businesses and regulators tended to think of corporate restructuring as interethnic sharing, while non-Malay businesses were more likely to regard it as unwarranted control.

In other words, there were discernible divergences in the way NEP’s vision was perceived. NEP’s architects stressed its national unity objectives, its (Malay) beneficiaries supported its remedial features, while those (non-Malays) adversely affected protested its discrimination. These divergences in perception were partly occasioned by the impact of the politico-economic adjustment that NEP entailed, which has been succinctly summarized by Khoo Khay Jin (1990, p. 50).

Whatever the sources of inspiration for NEP, it spelled a new phase in Malaysia’s development, overturning the relationship between state and economy and recasting the balance of power within the “pact of domination.” NEP spelled the end of an alliance between the Malaysian state and private capital in which the state was content to support the efforts of private accumulation, both local and foreign, restricting itself to limited programmes aimed at ameliorating rural discontent and the frustrations of a rising Malay intelligentsia. Instead the roles were to be reversed with the state playing the leading role and laying down the agenda with private capital in tow. The choice of this particular alternative expressed primarily the demands of the Malay business and intelligentsia network, many of the latter being in bureaucratic positions, who wanted the state to be interventionist in favor of ‘Malay’ interests. To the degree that state power depended upon its ability to command votes in the countryside, where poverty levels were atrocious, the policy also expressed incorporating intentions towards such strata, primarily the peasantry. In power terms, it spelled a shift of power to technocrats and bureaucrats. In implementation, it was geared towards the utilization of state resources to sponsor a Malay capitalist class. In realization, it assumed in large part the form of public corporations acquiring assets for and on behalf of Malays and run by political appointees and bureaucrats.

Under the circumstances, several factors were crucial to NEP’s acceptance and viability. Politically, the “NEP state” had to maintain a high level of governance capacity. Economically, NEP years
NEP: Problems and Tensions

To say that NEP gained a wide measure of acceptance is not to overlook several problems and tensions that arose from its implementation. A number of difficulties emerged in the first half of NEP’s two-decade span, but intensified during the second half, as well as when worsening economic conditions exposed the inefficiency of the bureaucracy and the limitations of state intervention and undermined the governance capacity of the Mahathir regime.

First, it was well known that the public enterprises (PEs) were, on the whole, economically inefficient. Their poor management, rapid expansion (for example, into new business areas), and lack of accountability led to heavy losses. In 1984, for instance, only 269 out of more than 900 PEs submitted their annual returns to the Ministry of Public Enterprises, recording a collective accumulated loss of RM137.3 million (Supian 1988). Ideologically, the PEs were too willing to consider themselves as social enterprises and to rationalize their losses as the price to be paid for Bumiputera advancement and learning.

Second, there was something of a parting of ways between what is commonly identified as a Malay public sector and the non-Malay (mainly Chinese) private sector. This was partly a result of the state’s strong interventionism, and partly because of the post-1969 rupture in relations between the state and (Chinese) private capital. The public sector generally regarded the private sector as rapacious, while the private sector considered the public sector to be inefficient and incompetent. Most non-Malay businesses resented the heavy hand of state regulation. Local Chinese capital tended to adopt a short-term investment outlook, preferring to concentrate their investments in nontradable sectors, especially property and construction (Jesudason 1989). Some foreign investors were probably discouraged from investing because of restructuring and other measures of the ICA (Marican 1987).

Third, the relatively easy access of Malay business to credit and contracts, their high failure rate in spite of the advantages, and the frequency of Ali-Baba arrangements caused concern that Malay businesses were becoming too accustomed to handouts, bailouts, and subsidies. The majority of Malay professionals, trained at state expense, looked to the state for employment. There were suggestions—some of the most pointed coming from Mahathir—that excessive state protection and preferential treatment had fostered a dole mentality that rendered too many Malays dependent on handouts, bailouts, and subsidies. The majority of Malay professionals, trained at state expense, looked to the state for employment. There were suggestions—some of the most pointed coming from Mahathir—that excessive state protection and preferential treatment had fostered a dole mentality that rendered too many Malays dependent on handouts, bailouts, and subsidies. The major- ity of Malay professionals, trained at state expense, looked to the state for employment. There were suggestions—some of the most pointed coming from Mahathir—that excessive state protection and preferential treatment had fostered a dole mentality that rendered too many Malays dependent on handouts, bailouts, and subsidies.

Fourth, there was a tension between NEP’s poverty eradication and restructuring objectives. In ethnic terms, few state-supported programs of “poverty eradication irrespective of race” were designed to serve the non-Malay poor, whether in the rural or urban areas; the official assumption was that poverty was predominantly a rural Malay condition. There was also a steady shift in emphasis from poverty eradication to restructuring, which benefited the new politically and bureaucratically well-connected Malay businesses disproportionately (Jomo and Ishak 1986).

Fifth, there was a persistent tension between growth and distribution. Some critics maintained that NEP’s restructuring retarded the country’s growth, although it is virtually impossible to prove whether the high-growth 1970s would have seen even higher growth without NEP’s interethnic distribution. But even UMNO

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6 For a BN component party’s views on the plight of the mainly Chinese “new villages,” which were poor but bypassed by official rural development efforts, see Partai Gerakan Rakyat Malaysia 1986.
and Malay business circles—generally those most devoted to restructuring—began to show a polarity of opinion between pro-growth and pro-distribution advocates when the national economy began to falter in the early and mid-1980s.7


The Mahathir era began when Mahathir succeeded Hussein Onn as prime minister in July 1981, about midway in NEP’s two-decade Outline Perspective Plan (OPP) period of 1970–90. The problems of NEP, outlined above, were well-known to Mahathir. He also would have known that a potentially divisive and bitter interethnic accounting on the attainments or shortcomings of NEP could take place as the end of NEP drew nearer. Mahathir stood in an unusual position in relation to NEP. When it was formulated in 1970, he was in a kind of political wilderness. He had lost his parliamentary seat in the 1969 election, and had been expelled by UMNO in late 1969 for openly blaming Tunku for the May 13 violence. Yet the general public impression, gained from following his controversial career as a Malay nationalist and reading his book, The Malay Dilemma, was that Mahathir was NEP’s ideological soul. He had advocated state-managed social engineering to restructure Malaysian society to promote economic advancement of the Malays. In government, since his 1974 appointment to the Razak cabinet he had consistently defended NEP, although he had his own reservations about the ICA and Malay economic performance.

Early in his term in the prime minister’s office, Mahathir appeared to have a socioeconomic agenda that differed in focus and priorities from NEP’s core concerns. Apart from reassuring everyone that NEP would be continued and fairly implemented, he proposed a starkly novel agenda for the nation. In short, he wanted a nationalist-corporatist venture to transform Malaysia into a newly industrializing country. He wanted his cabinet to provide leadership by example, the people to “Look East” to emulate an Eastern work ethic, the bureaucracy to become “clean, efficient, and trustworthy,” the public and private sectors to cooperate in a “Malaysia Incorporated,” and the economy to move ahead on the basis of privatization.8 He committed the state to heavy industrialization through joint-ventures with Japanese and Korean manufacturers of automobiles, motorcycle engines, steel, and cement.

Mahathir’s early economic policies and bureaucratic reforms came so quickly that, initially at least, what he was aiming for was not altogether clear to a lot of Malaysians. Generally, it was acknowledged that he had a modernizing vision and a nationalist mission. The bureaucratic reforms were just beginning, and his anticorruption campaign seemed less than wholehearted. But to a public long weary of bureaucratic ills, his reformism was welcome. To a public used to political detention without trial, his release of many political prisoners seemed quite liberal, although a battery of repressive legislation remained. Even his rather undiplomatic “buy British last” campaign

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7 For a candid and insightful analysis of this growth versus distribution split among Malay political and business circles, see Marican 1987.

8 “Leadership by example,” “Look East,” “Eastern work ethic,” “Clean, efficient, and trustworthy,” “Malaysia Incorporated,” and “Privatization” were all catchwords and slogans associated with the early Mahathir policies, examined at length in Khoo Boo Teik 1995.
and his spurning of the Commonwealth Heads of Government Meeting (CHOGM) in Melbourne in 1983 evinced some national pride in being able to stand up to the West. In sum, Mahathir, and his deputy, Musa Hitam—both former rebels against Tunku in 1969—managed to weave a populist, dynamic, reformist, and liberal aura over their “2-M (Mahathir-Musa) administration.” Vision, aura, persuasion, and leadership: these were critical, if intangible, factors in the enhancement of the early Mahathir regime’s governance capacity, as demonstrated by the incorporation of Anwar Ibrahim, president of ABIM (Angkatan Belia Islam Malaysia), into UMNO, and BN’s strong victory in the 1982 general election.⁹

In those early years Mahathir conducted himself as if he had all the answers to the problems spawned by NEP. His bureaucratic reforms seemed to speak to the issues of bureaucratic ineptitude and lack of fiscal discipline and accountability. Privatization, still in its infancy, appeared as an answer to the perennial losses of NFPEs and offered a way to distribute state assets to able and successful Bumiputera entrepreneurs. “Malaysia Incorporated” proposed to mend the rift between the public and private sectors now that there was a nationalist mission to accomplish. The work ethic, at once Eastern and Islamic, stressed the need for hard work and self-reliance and was offered as the corrective to Malay dependence. Exhortations do not ordinarily mean much in politics, but Mahathir’s exhortations were backed up by his bureaucratic reforms, industrialization drive, and Islamization projects (including the establishment of an Islamic bank and an Islamic university). These actions did much to prepare Malaysian society for change and adjustment under his leadership. By and large, Mahathir brought home the themes of change, adjustment, and innovation to many Malaysians in small, but personal, ways: for example, setting Peninsular Malaysia’s time back by a half hour to synchronize with Sabah’s and Sarawak’s and installing a punch-card system in all government departments. He had imposed a new agenda and a national purpose that was different from the old concerns of NEP, and moved toward the attainment of “NICdom.” It is critical to appreciate and remember this because, ironically, the Mahathir regime’s governance capacity was soon to be tested fully.

The Political Economy of Adjustment, 1985–86

The Malaysian economy began to slide into recession at about the time Mahathir came to power. Perhaps Mahathir and Finance Minister Tengku Razaleigh Hamzah underestimated the impact of the recessionary global economy on the national economy, or perhaps they took no chances with the 1982 general election. In any case, they responded to the recession by countercyclical spending through increased public sector consumption, investment, and employment. The economy had a mild recovery in 1983, but by 1985 it had fallen into a much worse recession, which lasted until 1986 (table 1). There were at least three major components to the 1985 recession—a global collapse in commodity prices; a sharp rise in public, especially foreign, debt; and a substantial decline in private investment.

⁹ Without this, Mahathir might not have locked horns with the Malay rulers whose prerogatives he tried to reduce during the constitutional crisis of 1983. The crisis ended in a stalemate, but Mahathir took advantage of more favorable circumstances to gain a major victory over the Malay rulers in 1992–93.
The Collapse of Commodity Prices

Practically all of Malaysia’s major commodities showed huge declines in earnings by the mid-1980s (table 2). With crude petroleum prices having fallen from US$36.5 a barrel in 1980 to US$14.7 a barrel in 1986, an even higher volume of petroleum exports earned less in 1986 than earnings in 1980. Palm oil earnings fell from RM4.5 billion in 1984 to RM3.0 billion in 1986. The tin industry in Malaysia had virtually collapsed by late 1985, when the International Tin Council Buffer stock manager ran out of money to maintain tin prices. The value of Malaysia’s tin exports in 1986 barely exceeded 25 percent of the 1980 figure.

During this period, the government authorized increased timber extraction given that sawlogs were the only primary commodity to sustain its prices. In addition, contractual exports of liquefied natural gas (LNG) to Japan, which had begun in 1983, grew in volume despite lower prices.

Table 1
Macroeconomic Indicators, 1973–93
Million ringgit

<table>
<thead>
<tr>
<th>Year</th>
<th>Fixed capital formation</th>
<th>Consumption/ GNP</th>
<th>Investment/ GNP</th>
<th>Exports/ GNP</th>
<th>Imports/ GNP</th>
<th>Real GNP growth</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>1,203</td>
<td>2,908</td>
<td>74.53</td>
<td>26.52</td>
<td>50.51</td>
<td>—</td>
<td>10.5</td>
</tr>
<tr>
<td>1974</td>
<td>1,644</td>
<td>4,154</td>
<td>78.73</td>
<td>25.93</td>
<td>47.08</td>
<td>46.61</td>
<td>7.67</td>
</tr>
<tr>
<td>1975</td>
<td>2,110</td>
<td>3,492</td>
<td>69.90</td>
<td>22.96</td>
<td>53.84</td>
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<td>2,505</td>
<td>3,701</td>
<td>71.47</td>
<td>24.03</td>
<td>52.20</td>
<td>44.39</td>
<td>11.42</td>
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<tr>
<td>1977</td>
<td>3,078</td>
<td>4,387</td>
<td>73.08</td>
<td>24.53</td>
<td>53.70</td>
<td>47.71</td>
<td>7.47</td>
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<tr>
<td>1978</td>
<td>3,419</td>
<td>5,058</td>
<td>67.02</td>
<td>25.15</td>
<td>60.27</td>
<td>50.31</td>
<td>6.59</td>
</tr>
<tr>
<td>1979</td>
<td>4,135</td>
<td>6,701</td>
<td>71.33</td>
<td>30.19</td>
<td>61.05</td>
<td>57.73</td>
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<td>5,338</td>
<td>9,559</td>
<td>76.11</td>
<td>34.72</td>
<td>54.44</td>
<td>60.87</td>
<td>8.55</td>
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<tr>
<td>1981</td>
<td>7,206</td>
<td>12,044</td>
<td>74.88</td>
<td>38.11</td>
<td>53.35</td>
<td>62.49</td>
<td>7.23</td>
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<tr>
<td>1982</td>
<td>11,378</td>
<td>11,367</td>
<td>72.44</td>
<td>38.48</td>
<td>54.62</td>
<td>60.72</td>
<td>10.16</td>
</tr>
<tr>
<td>1983</td>
<td>12,521</td>
<td>12,692</td>
<td>69.20</td>
<td>34.23</td>
<td>58.20</td>
<td>56.15</td>
<td>3.86</td>
</tr>
<tr>
<td>1984</td>
<td>12,046</td>
<td>13,345</td>
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<td>32.13</td>
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<td>53.59</td>
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<tr>
<td>1985</td>
<td>10,854</td>
<td>12,270</td>
<td>72.63</td>
<td>28.18</td>
<td>60.20</td>
<td>53.68</td>
<td>-1.26</td>
</tr>
<tr>
<td>1986</td>
<td>8,639</td>
<td>10,226</td>
<td>66.81</td>
<td>24.46</td>
<td>68.03</td>
<td>52.98</td>
<td>2.70</td>
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<tr>
<td>1987</td>
<td>7,271</td>
<td>11,009</td>
<td>67.45</td>
<td>25.56</td>
<td>71.62</td>
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<td>5.41</td>
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<td>1988</td>
<td>7,946</td>
<td>13,976</td>
<td>69.23</td>
<td>31.09</td>
<td>77.73</td>
<td>71.15</td>
<td>9.45</td>
</tr>
<tr>
<td>1989</td>
<td>11,097</td>
<td>18,966</td>
<td>69.60</td>
<td>33.85</td>
<td>80.12</td>
<td>78.04</td>
<td>9.13</td>
</tr>
<tr>
<td>1990</td>
<td>13,283</td>
<td>24,207</td>
<td>72.30</td>
<td>37.38</td>
<td>85.37</td>
<td>91.55</td>
<td>11.29</td>
</tr>
<tr>
<td>1991</td>
<td>14,749</td>
<td>31,432</td>
<td>67.98</td>
<td>36.14</td>
<td>82.15</td>
<td>80.33</td>
<td>7.46</td>
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<tr>
<td>1992</td>
<td>16,653</td>
<td>34,044</td>
<td>64.68</td>
<td>34.88</td>
<td>83.74</td>
<td>78.65</td>
<td>7.55</td>
</tr>
<tr>
<td>1993</td>
<td>18,632</td>
<td>36,836</td>
<td>63.28</td>
<td>35.13</td>
<td>85.32</td>
<td>80.19</td>
<td>8.70</td>
</tr>
<tr>
<td>1994</td>
<td>22,340</td>
<td>40,224</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>8.57</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Economic Report, various years.
These two exceptions to the general decline in commodity export earnings eased an otherwise (for Malaysia) unprecedentedly severe recession.

The overall effect of the commodities collapse on export earnings and state revenues was tremendous. Optimistic after a threefold increase in export earnings between 1975 and 1980, Malaysia’s economic planners had forecast total export earnings of RM63.1 billion in 1985; the actual figure turned out to be only RM37.6 billion!

**The Rise in Public Debt**

Malaysia’s public debt rose sharply during the first half of the 1980s. It had begun to rise in the 1970s as a result of deficit spending associated with NEP’s implementation (table 3). As real interest rates increased in the early 1980s (beginning from 1979 with the Volcker-induced deflationary liquidity contraction), Malaysia borrowed heavily from abroad. The Mahathir administration probably thought that it could spend its way out of the international recession. Much of its countercyclical spending came in the form of Isi Penuh (a massive civil service recruitment exercise), an expansion of NFPE activities (particularly those related to the heavy industrialization drive), and the commencement of some large-scale projects in infrastructure and heavy industry. One other factor was responsible for the rapidly escalating foreign component of the public debt—the sizable appreciation of the yen against the U.S. dollar following the G-7 Plaza Accord of 1985.

Total public debt, which stood at RM34.16 billion in 1981, rose to RM46.18 billion in 1982, RM57.83 billion in 1983, RM66.73 billion in 1984, RM72.43 billion in 1985, and RM87.06 billion in 1986, before it fell to RM82.43 billion in 1987 (see tables 4 and 5). The federal government foreign-debt-servicing ratio alone rose from 4 percent in 1980 to 13 percent in 1984, and to 39 percent in 1985 (although this last figure included some major loan prepayments).10

**Decline in Private Investment**

Total private investment declined from RM13.3 billion in 1984 to RM10.1 billion in 1986 (table1). Foreign corporate investment alone fell from a high of RM3,262 million in 1982 to

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10 For an extended analysis of Malaysia’s fiscal and debt problems of the 1980s, see Jomo 1990 (pp. 166–200).

**Holding NEP in Abeyance**

After fifteen years of continued high growth, the economy contracted by 1.0 percent in 1985 and managed to register a meagre 1.2 percent growth in 1986. Per capita GNP, having peaked at RM4,800 in 1984, fell to RM4,600 in 1985, and to RM4,100 in 1986, before rising to RM4,500 in 1987. This time around (1985–87) there was no countercyclical spending to cushion the recessionary effects. If anything, Mahathir and his new Finance Minister, Daim Zainuddin (who had been appointed to replace Razaleih in 1984), imposed heavy restraint on most public spending. The federal government’s development expenditure was severely reduced—the 1987 development expenditure of RM6,673 million was just over half the 1983 figure of RM11,670 million (table 4). Increases in operating expenditure werestringently held down, mostly by means of a job and wage freeze. Besides HICOM (Heavy Industries Corporation of Malaysia), which was engaged in Mahathir’s heavy industrialization

### Table 3

**Federal Government Surplus/Deficit, 1975–93**

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue (Million ringgit)</th>
<th>Operating expenditure</th>
<th>Development expenditure</th>
<th>Total expenditure</th>
<th>Overall deficit</th>
<th>Overall deficit/ GNP(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>5,117</td>
<td>4,900</td>
<td>2,113</td>
<td>7,013</td>
<td>-1,896</td>
<td>8.8</td>
</tr>
<tr>
<td>1978</td>
<td>8,841</td>
<td>8,041</td>
<td>3,699</td>
<td>11,740</td>
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*Source: Ministry of Finance, Economic Report, various years.*
projects, the PEs were subjected to tighter budget constraints, greater monitoring, privatization, and even closure.

The Mahathir-Daim regime of fiscal austerity and contraction in state expenditure contained bitter medicine for several groups. Unemployment shot up from a low of 5.0 percent in 1982 to 8.6 percent in 1987, and the total number of unemployed doubled between 1982 and 1986. For the first time since the expansion of the universities under NEP, graduate unemployment, of Malay graduates in particular, became a serious problem. Bankruptcy became frequent among businesses dependent on state support and contracts, with the hardest hit being the smaller Malay companies. These were mostly contractors whose main source of business had long been government contracts and jobs. Not only was there a reduction of allowances for senior bureaucrats, but these bureaucrats, along with those running the PEs, were publicly criticized and ridiculed for low productivity and inefficiency, and some were told to resign if they could not improve their performance.

Amid such economically difficult conditions, and facing widespread criticism over financial scandals and political crises, Mahathir led the BN to another victory in the August 1986 general election. A detailed analysis of that victory, and of UMNO’s landslide triumph against PAS (eighty-one out of eighty-two contests), is beyond the scope of this chapter. Suffice it to say that rising interethnic tensions, the prospects of a big DAP gain (which materialized), PAS’s poor electoral campaigning, and Mahathir’s political skills kept UMNO’s Malay constituency loyal to the party. Mahathir apparently considered this electoral triumph as a popular vindication of his policies.

Before the election in 1986, he had initiated several measures to stimulate growth. Guidelines for foreign equity ownership in manufacturing were liberalized in July 1985. The ICA was amended in December 1985 to make it easier for manufacturers to start new projects, expand their capacity, or diversify their products. In May 1986 the Promotion of Investments Act provided additional tax incentives for manufacturing, agriculture, and tourism. The state also launched a New Investment Fund to allocate funds at preferential interest rates for new projects in these three sectors. With his August 1986 electoral victory, Mahathir was ready to unveil the most drastic of his counter-recessionary measures—the suspension of NEP’s restructuring objective, or what he called keeping “NEP in abeyance.”

At the end of September 1986, he announced a set of new, more liberal conditions for foreign

---

Table 4

**Total Public Sector Debt, 1975–93**

<table>
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<tr>
<th>Year</th>
<th>Domestic debt</th>
<th>Percent of total debt</th>
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<th>Percent of total debt</th>
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*Source: Ministry of Finance, Economic Report, various years.*
Table 5

Outstanding External Debt, 1981–93

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<th>Federal government debt</th>
<th>Government guaranteed debt</th>
<th>Public sector debt</th>
<th>Private sector debt</th>
<th>Total debt</th>
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<th>Public sector debt, percentage of GNP</th>
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Note: These figures include drawings from the IMF facility in federal government debt and are thus higher than the Ministry of Finance figures.
a. NFPEs only from 1985.
Source: Bank Negara Malaysia, Annual Report, various years.

equity and expatriate staffing in an effort to attract new foreign investment. A company that exported at least 50 percent of its output or hired at least 350 Malaysian workers would be permitted to hold whatever level of foreign equity it requested. The only major stipulation was a requirement that employment in new foreign ventures should approximate the ethnic composition of Malaysia, and Mahathir promised foreign investors who committed investments between 1 October 1986 and 31 December 1990 that they would not be required to restructure their equity at any time.

Mahathir knew that placing NEP in abeyance could be politically risky. He justified it on entirely pragmatic grounds: without new investments, there would be no employment; without growth, there could be no distribution. The liberalization of foreign equity ownership in September 1986 was followed by another amendment to the ICA, so that only firms having more than seventy-five workers or RM2.5 million in paid-up capital had to comply with the ICA requirements. This was a major concession in NEP implementation to benefit local Chinese capital. Thus, the fiscal adjustments induced by the recession eventually led to deregulation, economic liberalization, and a virtual end to state intervention.

Responses to Adjustment

How was the overall adjustment-deregulation package received? There appear to have been no
clean class or monolithic ethnic cleavages in the response. Labor was generally too weakly organized and too divided to mount a coherent opposition to Mahathir’s initiatives. Workers in a sector such as tin mining, which had been virtually shutdown, or employees in the FTZs, which were effectively prohibited from unionizing, were not in a position to respond to the finance minister’s call for a voluntary three-year wage freeze (without a concomitant price freeze) in October 1986. One segment of labor that still had some bargaining power was CUEPACS, the Congress of Unions of Employees in the Public and Civil Services. For some time since Mahathir had become prime minister, CUEPACS had demanded a pay revision for government employees. After rounds of inconclusive negotiations, with the state intransigent and CUEPACS mildly threatening industrial action, the government decided not to run the risk of offending one of the state’s traditional electoral bases before an impending general election. In 1985 a 6 percent wage increase was granted to about 800,000 category C and D employees—that is, those on the lowest two scales of the civil service.

The urban non-Malay middle class had mixed reactions. It had been extremely discontented with the Mahathir administration’s handling of several financial scandals—the major ones involving Bumiputera Malaysia Finance (BMF), Pan Electric Industries (PanEI), Mamingo, the Employees Provident Fund (EPF), and Makuwasa. It had expressed its disaffection during the August 1986 election, sweeping DAP into most of the large, urban, non-Malay constituencies. But as a class, it was reasonably well-insulated against the (relatively short-lived) recession. It was not unfavorably disposed toward deregulation, suspension of NEP restructuring, privatization, and economic liberalization because it had long resented bureaucratic power, ineptitude, and shortcomings. For the urban non-Malay middle class, privatization, deregulation, and reduced state intervention implied fewer restrictions and greater opportunities. Holding NEP in abeyance had symbolic significance as well, given the non-Malay middle-class grievances against NEP’s ethnic discrimination.

Local capital, especially Chinese, generally welcomed the deregulation. The “NEP in abeyance” policy immediately satisfied their long-standing opposition, to the ICA in particular. Mahathir and Daim’s firmness in reducing state expenditure and debt, holding down wage levels, and reducing state intervention went down well with both local Chinese and foreign capital. Significantly, most of the larger and more successful Malay capitalists were not necessarily opposed to deregulation, especially those who gained from privatization. For those who had been groomed and protected by the state, but had succeeded and become economically more resilient, growth had a higher priority than distribution. They saw NEP’s protection of the Malays as less critical than the need to counter the negative impact of excessive intervention and regulation in economic performance.

This left essentially two social groups, who arguably lost the most from the Mahathir-Daim adjustment policies. One group comprised mainly small to medium-size Malay businesses badly affected by the contraction in state expenditure and the shortening of their lifeline of state contracts, finance, and assistance. This group of businesses saw the narrowing of state patronage as cronyism and blamed Daim. The other group mainly consisted of middle-ranking bureaucrats and PE managers, whose base in government and the PEs had been eroded. This group was more staunchly in favor of redistribution, and continued to press for a continuation or even an extension of NEP restructuring. One observer noted that relaxations on foreign investment, equity conditions, and the ICA, as well as the “strong undertaking to promote economic growth came as a major shock” to these groups of Malays (Marican 1987, p. 10).
Consolidation after the Crises: Vision 2020

During the period from 1987 to 1990, a good part of disenchantment with Mahathir’s adjustment policies was mediated through UMNO itself, and expressed in the form of Razaleigh’s initially strong, but ultimately unsuccessful, challenge to Mahathir’s leadership of the party and, by extension, of the nation. In the wake of this challenge and other opposition to the major policies of the Mahathir regime there were three major political crises: the mass arrest of opposition politicians, nongovernmental organization (NGO) representatives, and other dissenters in October 1987; the High Court declaration that UMNO was an illegal party in February 1988; and the sacking of the lord president of the Supreme Court in mid-1989. But Mahathir weathered all those political storms, and by the time he led BN into general elections for the third time, in October 1990, his position had been well consolidated. In November 1990 BN once more gained a comfortable electoral victory.

By then, however, the “politics of economic adjustment” had ended. The year of 1987 still saw modest economic growth of 5.2 percent, but from 1988 to 1990 there was an average annual growth rate of over 9 percent. Part of the turnaround arose from improved commodity prices and increased commodity export earnings, which climbed to RM28.97 billion from RM23.93 billion in 1985. By 1990, the value of manufacturing exports had risen to RM48.05 billion from RM12.47 billion in 1985, an average annual increase of 31 percent (Bank Negara Malaysia, Annual Report 1993). Manufacturing employment grew at an average annual rate of 12 percent between 1986 and 1990. The previous trend of declining private investment was reversed. In manufacturing alone, the proposed capital investment of all industrial projects approved for 1990 was RM28.17 billion, compared with RM5.69 billion in 1985. Foreign investments in approved industrial projects amounted to RM17.63 billion in 1990, compared with RM959 million in 1985. The principal sources of these post-1986 investment inflows were Taiwan (China), Japan, and Singapore, economies that were prompted to relocate some of their manufacturing activities because of rising production costs, tightening labor markets, and stricter environmental restrictions at home. Such considerations would have combined with a post-1986 investment regime of liberal equity requirements, easier start-up conditions, substantial ringgit depreciation, and lower labor costs to make Malaysia an attractive site for industrial relocation.

From the point of view of understanding vision acceptance and governance capacity in relation to structural adjustment and economic reform, the fact and scale of Malaysia’s dramatic economic turnaround are far more important than whether one can disaggregate the differential effects of home-based factors as opposed to Mahathir’s policies on the decisions of foreign investors. Mahathir could well claim that he and Daim contained the recession by their austerity drive, boosted foreign investment by suspension of NEP, and stimulated economic growth by their reliance on the private sector. Certainly he would have considered the expansion of the manufacturing sector to be a sign that his vision of NICdom was not far from being realized.

The empirical evidence of a strong post-1987 economic performance would have been enough to vindicate Mahathir’s policies, not just in his
Bibliography


Economic Strategy and Structural Adjustment in Tanzania

Brian Van Arkadie

This chapter analyzes some of the aspects of Tanzanian policymaking that have contributed to the strengths and weaknesses of the economic reform process during the past decade. The main thesis is that successful reform resulted from the accommodation of changes that had already begun in response to the deepening crisis of the economic system, but that the effect of the crisis and some of the reform measures has been to weaken the capacity of the state so severely that it is difficult for government to perform effectively the public functions necessary for the progress of the reformed economic system.

Origins of the Economic Crisis

Radical Change Following Independence

In Tanzania, the need for structural adjustment in the 1980s had its origins in both the negative events in the international economy and the failure to adjust policies swiftly enough in response to the initial shocks. In many respects, the evolution of the Tanzanian economy since independence and the events that led to structural adjustment are quite similar to those experienced by many other African countries. Another, and perhaps more interesting, part of the story is more particular to Tanzania: the crisis in the national model of development that had incorporated the vision the charismatic independence leader, Julius Nyerere. That crisis was brought to a head by exogenous shocks. Whether the system would have sustained itself in more propitious external circumstances is a matter for historical speculation, but faced with deep crisis, reform was unavoidable.

The economic reform process, as it came to be understood in the Tanzanian context in the 1980s, had four main elements:

1. stabilization, through the use of orthodox macroeconomic policy instruments to restore

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1 In an early comment (Van Arkadie 1983) on structural adjustment in Tanzania, I argued that the evident need for stabilization and some institutional reform should not be used as leverage to enforce dismantling of the existing economic system. In retrospect, although I remain critical of some aspects of the structural adjustment orthodoxy of that period, I recognize that I underestimated the depth of the malaise in the Tanzanian system at that time.
macroeconomic balance, both domestic and external;
(2) liberalization, reducing bureaucratic controls and government allocation of resources, and opening areas of the economy to private business that had been public sector monopolies;
(3) reform of state enterprise and privatization;
(4) reform of the government itself to enhance government capacity.

Some of the policy issues on the reform agenda, particularly in relation to stabilization, could be seen as more generally technical in character (although even issues such as the exchange rate, which are sometimes considered entirely technical matters, had strong political implications). Many of the policy issues, however, had obvious ideological content, particularly those related to liberalization and privatization, because they implied dismantling the system created following the Arusha Declaration.

The Arusha Declaration, issued by the ruling party, the Tanzanian African National Union (TANU, later renamed CCM), in February 1967 engendered international approval because of its emphasis on the priority attached to rural development, its rhetoric of self-reliant development, and its commitment to egalitarian economic and social policies. The Arusha Declaration seemed to incorporate a clear vision of Tanzanian development, which was implemented with great vigor by a charismatic and honest leader. The argument in the declaration was that self-reliance and egalitarianism could be best achieved by combining a leading role for the state in all large-scale activities with the promotion of rural development through cooperative agriculture (rural development based on the principles of “Ujamaa”).

With its emphasis on rural development and concern for the broad spread of the benefits of economic growth (in essence an early espousal of what later became known as a “basic needs” approach), important parts of the Arusha vision seem as valid today as they did in 1967. It is of some interest therefore to consider whether the economic difficulties that engulfed the Tanzanian economy demonstrated the fundamental unsoundness of the Arusha vision—its impracticality despite its Utopian attractions—or whether the problem lay in the faulty implementation of basically sound ideas. In the contemporary Tanzanian political debate, both explanations receive support.

One important element in the evaluation of the Arusha vision depends on interpretation of the degree of consistency between policies implemented and intentions, as stated in the declaration. Particularly in the period beginning in 1972, policies were implemented that arguably were inconsistent with the positions developed in the Arusha Declaration. The formulation of the Basic Industrial Strategy involved a definite shift from the priority given to rural development in the declaration. There was increasing centralization of economic authority and urgency in the implementation of programs. The attempt to enforce the villagization (“Ujamaa Villages”) program over two years, the abolition of cooperatives and local government, and the commitment to achieve universal primary education in two years all reflected an impatience to achieve political goals swiftly, even if it meant the loss of the principle of decentralized participatory rural development associated with the Arusha Declaration rhetoric and downplaying realism in the implementation of policies. At the same time, the emphasis on the ascendancy of politics—and politicians—over the bureaucracy and workers’ participation in the management of state enterprise seemed to incorporate a heightened political radicalism, although at the expense of weakening the self-confidence and role of technocrats.

The reasons for the heightened radicalism in the 1970s are not entirely clear, and cannot be established in this chapter. One possible explanation is that most of the policy criticism
came from the intellectual left. Nevertheless, it is unclear how much support the left—which argues, for example, in favor of the basic industrial policy—could summon. President Nyerere seemed able to ignore or contain criticism from intellectuals with little difficulty. The explanation for the period of heightened ideology probably lies in the evolution of the thinking of Nyerere himself, who exhibited an increasing impatience with technocratic conservatism and a belief in the need to accelerate the development process. Aspects of the extension of state control also had a more pragmatic element, in that it reflected an effort to defend established priorities in the face of the economic crisis of 1973. By the mid-1970s the degree of state intervention and central economic control had gone well beyond that envisaged at the time of the Arusha Declaration.

Insofar as a quasi-planned socialist economy was created, economic reform involved not merely a technical change in economic policies, but also a more thorough change in the economic and social system. The transformation was not equal to those of Eastern Europe and the Commonwealth of Independent States (CIS), because Tanzania had remained a mixed economy, but it did imply fundamental institutional change. Economic reform in Tanzania was therefore more intensely political than the customary reform process—it involved comprehensive change in economic institutions, and eventually in political institutions as well.

The need for reform was evident at the beginning of the 1980s, when the economy was faced with a deep crisis. The immediate symptoms were an extreme shortage of commodities, the result of a crippling shortage of foreign exchange, which in turn reflected such long-term phenomena as stagnation in export crop production, excessive dependence on donor support, and low productivity of the public sector investment programs in industry and infrastructure.

The economic system facing the crisis had been created following independence, which had brought economic policy change in four major areas:

- **The growth in public spending accelerated,** not merely in response to the ambitions of the new government, but also because two other developments made it possible to translate ambition into practice. Development aid broke the link between domestic savings and investment and funded development spending with too little regard for the recurrent resource base to sustain the expanded activities. In addition, the monetary restraints of the colonial financial system were ended as the colonial Currency Board gave way to the new Central Bank, allowing for monetary and fiscal flexibility and a break in the link to sterling.

- **There was a decisive shift in control over the economy.** Change was initially concentrated in the staffing of the public service. The rapid localization of the bureaucracy was one of the first priorities of the new government. But with independence, a lack of congruence emerged between political and economic power. It was no longer acceptable for Africans to be limited to the roles of peas-

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2 This was the view developed by N. Lipumba in commenting on an earlier draft of this chapter. He was in Tanzania at the time, and places emphasis on the influence of the "leftist" critique raising the ideological content of Tanzanian politics and contributing to the gap that he sees as emerging between policy intentions, as set out in the Arusha Declaration, and practice, as implemented in the period from 1972 to the mid-1970s. While there was such a debate—involving, for example, intellectuals at the university—it is difficult to judge how far polemics affected government decision-making. By and large, Nyerere seems to have been fairly impervious to such influences. The alternative explanation may be sought in the character of Nyerere himself, who had become increasingly confident of his capacity to override technical arguments suggesting caution, as he had done successfully in the initial implementation of the Arusha Declaration, and at the same time placed increasing faith in the potential for using the party for mass political mobilization to accelerate development.
Governance, Leadership, and Communication: Building Constituencies for Economic Reform

ant and worker. Either expanded public ownership or public support for the transfer of wealth to an emerging African property-owning class (as in Kenya) inevitably appeared on the political agenda; in Tanzania, this issue was confronted in 1967 in the Arusha Declaration.

- There was an impressive expansion in social service provision in the early 1960s, and the Second Five-Year Plan (1969–74) set out a strategy similar to what some years later became known in the donor world as “basic needs.”

- The fourth, and least desirable, change was the expansion of military expenditure. Tanzania was neither militaristic nor aggressive, but sovereignty had implications for necessary military spending. The imperial regime enjoyed economies of scale because of its ability to move forces from colony to colony, an efficiency lost as each newly independent country faced the need to form a national army.3

Despite the greater short-term fiscal and monetary flexibility gained by the replacement of the Currency Board by the Bank of Tanzania, over the long term the real resources available to government from domestic sources were constrained by the growth of export earnings, which in turn were affected by the vagaries of international markets, technology in the primary production sector, and the incentives provided to farmers. In the 1970s, the combination of ambitious fiscal expansion and the costs of the expansion of the public sector placed an increasingly heavy burden on the export sector. As the budget expanded and the single-channel (monopoly) marketing system became increasingly expensive, the export sector was squeezed, and export production faltered.

Although the First (1964–69) and Second (1969–74) Five-Year Plans were intended to diversify the economy, and the Basic Industrial Strategy, devised during the Second Plan period, aimed to accelerate the pace of industrialization, industrial investment failed to generate either much export diversification or real import substitution. Import dependence was not reduced, and industrialization through import substitution effectively increased structural dependence on imports by encouraging the creation of industries that could only operate with imported inputs. At the same time, the donor-financed projects crucial to development had extremely low average productivity. As declining export performance and negative shifts in international terms of trade reduced foreign exchange earnings, the initial response was to attempt to defend the resources at the disposal of the state and its functionaries.

The Agricultural Institutional Environment

Crucial to a consideration of the origins of the Tanzanian crisis and the need for reform is the institutional structure conditioning agricultural performance. Despite the extension of public ownership after the Arusha Declaration to include most large-scale economic activity, the bulk of the population remained outside the state sector, living and working on smallholdings; the typical unit of production remained the household.4

Given the dominance of smallholder farming, policies toward agricultural marketing were the most important government influence on agricultural performance. The postindependence policy had been to promote single-channel marketing through a chain running from the

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3 In Tanzania, the problem of managing the army was thrown into sharp focus when the army mutinied in January 1964. Later expansion in the army is in part to be explained by instability in neighboring countries, which eventually led to the Kagera (Idi Amin) War with Uganda, 1978–79.

4 In the early 1960s, about half of export production (most notably cotton, cashews, robusta coffee, and a significant proportion of arabica) and the lion’s share of food was produced on smallholdings (see Van Arkadie and Ghai 1969).
primary cooperative, to the cooperative union, to a marketing board, with monopoly enforced at each stage. The effort to extend the cooperatives beyond the areas where they had thrived as voluntary institutions to become a universal, but imposed, marketing mechanism had created an inefficient system (in 1966, it had already proved necessary to convene a presidential commission of inquiry into the cooperative system). Moreover, where the cooperatives had flourished before independence—such as the coffee and cotton-growing regions—they posed a political dilemma as an alternative to the party as a focus of local political power. The solution adopted in 1973 was to abolish the cooperatives and to amalgamate the local marketing functions, the previous activities of the marketing boards, and some of the extension responsibilities of the Ministry of Agriculture under newly created crop authorities. These large monopolies were unable to deliver what was expected of them, and their inefficiency became a prime cause of the deterioration in agricultural incentives, despite subsidization of loss-making crop authorities, which became a heavy budgetary burden.

Another aspect of institutional policy that commanded international attention was the Ujamaa Village program. When the Second Five-Year Plan was published in 1969, a commitment was made to extend the principles of Ujamaa (Nyerere's vision of socialism) throughout the countryside by promoting Ujamaa Villages. The villagization program, implemented in 1973–76, sought to transform the pattern of rural settlement by congregating the rural population—which previously had been resident predominantly on dispersed family smallholdings—in nucleated villages of sufficient size to be efficient (in bureaucratic terms) units for the delivery of services. Involved in this plan was the idea that the new villages could also become the basis for a socialist system of production.

The program was massive, although not universal, in extent. The effect of the program on production remains unclear. There must have been considerable short-term disruption, because production areas were lost and energies were diverted to building the new villages. In some areas, villagization created an increased risk of environmental degradation. Nevertheless, the only case widely presented to demonstrate large, long-term output losses from villagization is that of cashew nuts. Even if it is not possible to establish that villagization had a strong negative effect of production, however, it certainly diverted energies from activities that could have en-

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5 It could be argued that there was a basic political contradiction in the rural development strategy of government. The rhetoric tended to emphasize a decentralized and voluntary ideology of rural development, an aspect of Nyerere's thought that added to its international appeal. If genuinely spontaneous local institutions developed, however, they were likely to be identified as a threat to the authority of the party, as was the case with the Ruvuma Development Association, which seemed at the time to be implementing the Nyerere philosophy, but was nevertheless abolished.

6 The burden on farmers resulting from the inefficiency of the crop authorities was initially documented in a series of studies by Frank Ellis, Economic Research Bureau, University of Dar es Salaam.

7 The Ujamaa Village was probably Nyerere's most famous innovation, and also his greatest failure. There is not the space here to comment on that experience, except to note the great gap between the initial conceptualization, which emphasized the spontaneous and voluntary nature of the experiment, and the eventual mass implementation, which was managed and bureaucratic.

8 Important areas seem to have been largely untouched, such as the main coffee-growing (and therefore more developed) areas of Kilimanjaro and Kagera. The central, southern, and coastal areas of the country were extensively affected. Claims were made that after the completion of the program more than 90 percent of the rural population lived in villages; it is not possible to evaluate that claim because of lack of data and definitional ambiguities in the concept of the "village." For a critical (from the left) account of the Ujamaa Village experiment, see von Freyhold 1979.

9 The argument runs that with dispersed settlement, it was easy to tend a stand of cashew trees around the house with very little labor time. Once settlement was concentrated, it was not possible to plant around the house, while the existing stands would generally be some way from the new settlement. Certainly, cashew-producing areas were subjected to intensive villagization, and there was a severe loss of output. There were other plausible causes for the decline, however, such as unattractive prices and disease problems.
hanced productivity. Little was achieved in the nature of socialist production, and although there was a substantial effort to extend social services in the rural areas, much of the progress at the village level was eroded during the subsequent economic difficulties. 10

Institutional weaknesses contributed to the long-term malaise in export crop performance. In the 1970s agricultural export production declined, in striking contrast to the buoyant performance of the 1960s. In summary, costly marketing arrangements severely reduced returns received by farmers. Other negative factors included sweeping institutional changes, such as the abolition of cooperatives, villagization, and decentralization; poor design, by donors as well the Tanzanian authorities, of programs to promote agricultural innovation; long-term shifts in market prospects (for example, for sisal); and unfavorable weather. Moreover, the burden of a monopolistic marketing system meant that macroeconomic adjustments to improve farm incentives were inadequately passed on to the farmer (at the extreme, increasing official producer prices made little sense if farmers were not paid, or paid after long delays, as often happened).

1973: The First Economic Crisis and the Response

The Tanzanian economy proved vulnerable in the face of the new international economic disorder of the 1970s. In 1972–73 the system entered its first period of great economic difficulty. How the initial causes can be divided between exogenous shocks and policy failure remains a matter of debate. 11 The weakness and inflexibility of the export base demonstrated the validity of the shared premise of many policymakers throughout Africa in the 1960s that fundamental structural change was needed, but Tanzania found neither the means nor the time to effect the transformation before the onslaught of hard times. Even if economic difficulties had exogenous origins, policies were of varying effectiveness in responding to them. Domestic policy weaknesses included the excessive buildup of public expenditure, which placed pressure on available resources. The main proximate causes of the economic crisis, however, were two sets of exogenous shocks: drought resulting in harvest failure and the sharp deterioration in the terms of trade following the first oil shock. It was not perceived as a crisis in the system as such. 12

With access to increased aid, and the eventual recovery of the terms of trade (the result of the boom in coffee and tea prices in 1977–78), the system weathered the crisis without the sort of adjustment and liberalization measures that later emerged as the structural adjustment package. Response to crisis was actually in the reverse direction—government responded to an increasingly tight economic situation by increasing government control over the economy. Why was the system able to avoid adjustment in the 1970s,
while not being able to do so a decade later? Apart from the fortuitous improvement in the terms of trade in 1977–78, another striking difference was the response of the donor community. Finance provided by the IMF (under the Witteveen and other facilities) during the first crisis had much softer conditionality than would be the case ten years later. The period after 1973 also witnessed a rapid build-up of aid; the Nyere vision proved attractive not only to a number of bilaterals, but also to the World Bank under President Robert MacNamara. This provided a much more sympathetic donor environment than was the case in the early 1980s—the World Bank had turned sour, the IMF was pursuing harsher conditionalties, and even the more sympathetic bilaterals were not willing to expand their support.

In the first half of the 1970s, weakness in the managerial capacity of the state was not yet evident, and the authority of the political leadership was at its highest, so that an aggressive, interventionist response to economic difficulties carried some credibility. In response to the crisis of the early 1970s, a number of decisions about the tactics of economic management moved the system in the direction of a controlled, command-style economy. Controls were increased to defend the state’s access to increasingly scarce resources. Efforts to shield the domestic economy from the full force of the changing conditions included defending the existing exchange rate, when in retrospect it would have been better to have made a quicker response to new, harsher realities. Instead, pressure on the balance of payments was met by procedures to tighten government control over the allocation of increasingly scarce resources, such as the extension of controls over foreign exchange, imports, and credit allocation.

Over the same period, inflationary pressures threatened the carefully designed prices and incomes policy, which had been a centerpiece of economic management in the post-Arusha economy. Steps to equitably share the burden of economic difficulty included further compression of official wages and salary differentials and the extension of the system of price controls. The policy response to the first round of economic crisis also included popular mobilization efforts, such as a mass drive to expand food production.

The response to the crisis of the early 1970s was thus to increase the role of administrative allocation of scarce resources (particularly foreign exchange) and government control over incomes and price movements, rather than to seek a new equilibrium through price adjustment. Nevertheless, at no time was a clear strategic decision made to opt for a “planned” or command economy in preference to the use of market tools (see Green, Rwegasira, and Van Arkadia 1980 for a sympathetic account of efforts to manage the economy).

It is difficult to judge how effective the Tanzanian state was in enforcing its priorities. Although it is difficult to pinpoint the timing of the decline in state capacity, however, it is evident that the overextension of the role of the state placed great pressure on its capacity, while the heightened ideological content and politicization of the government decisionmaking process eroded the authority and self-confidence of the bureaucracy. By the end of the decade there had been an erosion in the capacity to carry out the economic management tasks of government.

1979: The Second Economic Crisis

By 1979 a new economic crisis had taken hold that was much deeper than GDP data, which could be interpreted to imply a modest dip in the level of economic activity, would suggest. Constraints on the availability of imports led to what was described as a goods famine—even the most basic goods disappeared from markets. The cumulative effects of weakness in public sector administration were exacerbated by the foreign exchange shortages, so that deterioration in the maintenance of infrastructure became more acute. There was considerable inertia, shared by donors and government alike, in persisting with investment programs that were no longer viable. It made increas-
ingly less sense to use available finance to fund new capital projects, which only added to already idle capacity, particularly when the existing public capital stock was rapidly deteriorating. Tanzanians became increasingly aware that the fairness and honesty of the public service was declining.

In weighing the relative importance of internal and exogenous factors that brought the Tanzanian system into acute crisis in 1979 (see Stewart and Sharpley 1985), a judicious balance can be struck by noting that decline in export production and evidence of increasingly ineffective performance in the parastatals suggest that the system was stagnating, but that exogenous shocks were so severe that there would have been a serious economic crisis even if the underlying economic performance had been much better. Negative exogenous influences included the end of the brief tea and coffee price boom; the breakup of the East African Community, with the consequent disruption of services and the need to replace them at the national level; the second oil shock; and the heavy burden of the war with Uganda (the Kagera, or Amin War, which began following border incursions and territorial claims by Amin, and was completed with the ouster of the Amin regime from Uganda).

There may have been an interplay between the dramatic political events of the period and the approach of the Tanzanian leadership to economic policy dialogue. Success in the Kagera War may have emboldened the leadership in other spheres, so that when Tanzania found itself in conflict with the IMF, it was not only possible for Nyerere to interpret the differences as essentially a political dispute, but also to see it as a dispute that could be won (I owe this insight to N. Lipumba).

The Kagera War had another effect: there was a general deterioration in the probity of the Tanzanian public service, which was faced with a sharp deterioration in the real value of official salaries associated with the difficult wartime conditions. This was compounded for public servants transferred from East African Community service to employment on much less advantageous terms with the Tanzanian government after the Community’s breakup. This transfer included inland revenue and customs staff, and any deterioration in the morale and performance of these cadres was of real significance to the economic management capacity of the government.

One reason that the crisis at the end of the 1970s was readily interpreted as external in origin was that the dominant feature of the crisis was the shortage of foreign exchange. The severe import constraint was associated with the sadly inadequate benefits generated by the substantial investment program implemented in the 1970s (see Tanzanian Economic Trends, 1988). Imbalances built up between new investment and the inadequate provisions to maintain the existing capital stock, between capacity expansion and the availability of foreign exchange to fund recurrent inputs, and between plant expansion and the technical and managerial know-how to operate the new plants. Most strikingly, the large program of industrial investment initiated in the mid-1970s generated no increase in industrial output because of import dependence, infrastructural bottlenecks, and design and managerial weakness (see Skarsstein and Wangwe 1986). Thus, underlying the short-term economic management problems that confronted the government was an increasing structural weakness. The economy was becom-

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13 And, indeed, by the 1980s virtually all the economies of Africa were in crisis, even those touted at one time or another as models of successful market-orientated development (such as Kenya and Côte d’Ivoire).

14 There is an interesting parallel between the donor reaction to the Amin ouster and the roughly contemporaneous ejection of the Pol Pot Cambodian regime by the Vietnamese. In both cases, an innocent might have supposed that the invading forces were providing an unequivocally positive service to the world community by ejecting particularly obnoxious regimes, but in both cases the international reaction was negative—nonsupportive in the case of Tanzania and outright hostile in the case of Vietnam. Possibly such adventures are viewed as the exclusive preserve of the great power(s)?
ing more import dependent, while domestically generated funding for imports was stagnating. More subtly, the combination of increasing scarcities (and accompanying rent opportunities) with compression of salaries had created the conditions for the erosion of the probity and commitment of the bureaucracy.

**Governance and the Managed Economy**

To use the current vocabulary, how should the “governance” of Tanzania, before the crisis of the late 1970s and the reforms of the 1980s, be characterized? There was a paradox in the condition of the Tanzanian state, demonstrated in the contrast between decisive leadership at the top—consistent with a quite “hard” state, capable of making and implementing difficult decisions and mobilizing mass support behind development projects—and a system of government with attributes of the “soft” state—with lax administration and a great gap between intention and achievement in the implementation and management of even routine government activities, such as road repair. Political scientists have explored that paradox (van Cranenberg 1990 deals with this paradox; see also Hyden 1980, 1983).

Governance can be seen as having two different aspects. The first is the effectiveness of the political system in maintaining stability, coherence, and legitimacy in response to the political interests in play. In this area the Tanzanian system scores well in some respects, particularly when viewed in the context of African political instability. The second area includes the managerial capacities and probity of state organizations, and here the Tanzanian record is less satisfactory. One source of weakness was the limited initial human capital stock at the time of independence, when there was inadequate national manpower, in striking contrast to the situation in most Asian and Latin American countries. The imperial bureaucracies of Africa had a history that was too brief, and locals were introduced to the system too late to have created anything like the Indian Administrative Service, or to have laid down the deep historical roots of the Mandarin tradition that has influenced many parts of East Asia. The Tanzanian human capital stock was fragile, even when compared with other British colonies in Africa, such as Ghana or Uganda.

A bureaucratic elite swiftly emerged following independence. It was often professionally competent, but its consolidation was impeded by disruption, following the Arusha Declaration, when many of the most able civil servants transferred to manage the new parastatals, spreading available talent very thinly. The administrative system was next subject to a frenetic sequence of reorganizations. In addition, the emphasis placed on political leadership and the role of the party, particularly in the early 1970s, stunted the growth of a self-confident bureaucratic elite—in part, intentionally. The weakness of the civil service made the system highly vulnerable to poorly thought out external proposals for administrative reform (in the early 1970s, the consulting firm of McKinsey was a particularly influential adviser on reform).

As the supply of qualified nationals increased, there was a systemic failure to utilize trained staff effectively. Part of the explanation is that in the postindependence decade too many tasks were loaded onto a bureaucracy still handling transition from the colonial authorities, overburdening administrative capacity when it might have been wiser to consolidate. Part of the “hard/soft” paradox arose from the contrast between a strong political leadership, driving to extend state management of the economy, and a weak bureaucratic

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15 By the end of the 1970s, a slightly ironic usage had developed among senior civil servants, in which responsibility was implicitly disclaimed by reference to the “policymakers,” that is, the politicians, who were seen as having essentially taken all control and responsibility out of civil service hands.
apparatus, allocated the task of managing the new system. Even if there was no attempt to introduce a full-fledged command economy, the expansion of state ownership after 1967 and the extension of the planned allocation of scarce resources in the early 1970s stretched an already overburdened administration.

The overextended civil service found it increasingly difficult to induct new staff effectively, leading to a decline in morale, which accelerated with the decline in real incomes that followed the squeeze on the real resources at the disposal of the state in the early 1970s. The civil service sense of responsibility and accountability for the effectiveness of policy was also eroded by the primacy of the party and politics over administrators and technical considerations. The result was a decay of administrative systems and a consequent dis-investment in human capital: new entrants into a decaying bureaucratic milieu were exposed to a process of unlearning by not doing.

If inadequate numbers of trained staff had provided a plausible explanation of weaknesses in state capacity in the 1960s, it was much less convincing by 1980. While gaps remained in particular technical and scientific skills, the stock of human capital, at least as measured by formal qualifications, had been transformed. While in the 1960s it was necessary to draft scarce graduates into the public service through bonding schemes, by 1980 disguised graduate unemployment was widespread in the public service, with an excess of graduates employed.

To emphasize the weakness of the bureaucratic structure is to emphasize the technocratic aspect of the content of governance. Turning to the political element, although the system can claim to have delivered national stability, in other respects the achievement fell short of expectations. Given the rhetoric of President Nyerere and the party, it might have been hoped that what was lost in bureaucratic competence might have been gained through grassroots mobilization. Numerous studies, however, have indicated that although the party was remarkably effective in organizing a political machine throughout the country, it was subject to the basic contradiction that development of the party structure was at the expense of the creation of autonomous, grassroots institutions (see von Freyhold 1979; van Cranenbergh 1990; Finucane 1974; Shivji 1976). The abolition of local government, cooperatives, and the Ruvuma Development Association (RDA) and the contradictory reality of government “decentralization” could be seen as part of a pattern of concentration of power in the party. Nevertheless, having laid claim to a monopoly of leadership in development, the party was ill-equipped to carry out its self-imposed task.

Phil Raikes (University of Dar es Salaam, Economics Research Bureau), in a pungent comment, suggests the destructive impact this had on agriculture:

> Leaders whose knowledge about agriculture, economics, or the constraints of peasant farming were minimal, felt free, indeed obliged, to issue directives, to show their commitment. A significant proportion of ... extension advice was already of dubious value ... further simplification ... increased the proportion which was irrelevant or technically incorrect. ... Apart from the considerable waste of time and/or energy involved in either complying with or evading directives, they appear to have contributed significantly to a decline in morale: a feeling that whatever one does to try to organize one’s life sensibly, some clown in office will come along and mess it up.

Another aspect of the Tanzanian paradox resulted from the weakness of national interest groups pressing the state to provide effective economic services. Although the absorption of virtually all graduates into public service—in government and the parastatal sector—eventually undermined both the performance and the real incomes of graduates, it also meant that the educated elite were almost entirely co-opted into the official system. When it is also remembered that there was a very limited indigenous
business class, the striking lack of opposition through extended periods of economic difficulty is not difficult to understand. The weak development of an autonomous middle class permitted a high degree of apparent relative autonomy of state action in the years following independence, as demonstrated by the surprisingly uncontroversial implementation of socialist measures following the Arusha Declaration. At the same time, there was an absence of pressure groups agitating for effective performance from the state, or of entrepreneurial groups capable of manipulating the state to support their own schemes of accumulation. The colonial authority itself had been relatively free of pressures from local interests. With independence, colonial power was replaced by a nationalist movement supported by the broad mass of workers and peasants, but unattached to the local concentrations of economic power, which were largely non-African. The mass of the population could not be expected to play an active role in influencing policy—the peasantry expressed its discontent mainly by the passive resistance of withdrawal from the market, and workers could mobilize to defend a particular interest, but neither group could demand effective economic performance by the state. Nor did the parastatal managerial elite have any particular stake in efficiency as such, because for many years they could fund their empires with borrowed capital.

Politics of Reform: Economic Disequilibrium as a Source of Change

Reform did not come in one discrete jump, but was the outcome of a somewhat tortuous process over the decade of the 1980s (see Mans 1992 for a systematic review of the steps in structural adjustment). The changing stance of the government can be traced from the denial of the need for reform in 1979–80, to the acceptance of some modest reforms in the Structural Adjustment Program of 1982 and the agricultural policy adopted at the same time, to the agreement of the Economic Recovery Program with the IMF and World Bank in 1986. During those years, there were contradictory movements in policy, and the process was described as “ambiguous” in its intent as late as 1986.

The distance of the movement in policy attitudes can be seen by comparing the reports of two presidential commissions, one reporting at the beginning of the 1980s, the other at the end of the decade. The Mbylini Report on Agriculture (Professor Simon Mbylini was assistant to the president, and later principle secretary, Ministry of Agriculture), prepared in 1982 (Tanzania 1983), made only very subtle arguments in support of liberalized marketing, arguing the half-truth that local trade in food should not be restrained because it was a long-standing, “traditional” activity. In contrast, the Nyaribu Commission (Charles Nyaribu, retired governor of the Bank of Tanzania, and later ambassador to Washington) on the financial system, reporting in 1990, felt free to support thorough financial liberalization. In both cases, the commissions were drawn from the government and party establishment, and the members had similar backgrounds, but over the intervening years there had been far-reaching changes in what was understood to be politically acceptable.

Reform was supported from the early 1980s by many Tanzanians, including numerous public officials, in light of the obvious debacle of the established policy regime. Reform, however, represented a defeat for the Tanzanian political system. The party leadership, finding it no longer possible to command the resources required to sustain the system, had to accept a retreat. Nevertheless, the liberalization of imports and other initial reforms implemented in the last year of Nyerere’s
Given one-party politics (until very recently), there was little open debate to serve as a measure of public sentiment that might require response from political authorities. During the period in which there was stiff official resistance to exchange rate adjustment and price decontrol, there was a concern among the political leadership about negative popular reaction in light of reactions to price decontrol elsewhere in Africa. But given the lack of hostile reaction to liberalization when it was eventually implemented, it seems likely that such a political assessment was wrong. It was evident in the early 1980s, however, that there was a significant current of opinion that was at least deeply cynical regarding the established economic policies.\(^\text{17}\)

The attitude toward a change in policy regime must be influenced by interpretations of the nature of the crisis of the old regime. Even after more than a decade of reform, however, no consensus has emerged regarding the origins of the crisis. There are at least three positions implicit in discussions of public policy in Tanzania:

- The stated view of many party and government leaders continues to be that the goals articulated in the Arusha Declaration were fundamentally sound, and the crisis is to be explained by a combination of implementation errors, perhaps resulting from hastiness, and exogenous shocks. That is, there is

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16 Nyerere retired from the presidency in 1985, when he did not seek reelection, and from the leadership of the party two years later. In his last year in office, the government acknowledged that it would have to accept substantial reforms in order to negotiate renewed support from the Bretton Woods institutions and the bilateral donors aligned with them. This was a pragmatic response to the realpolitik of the aid process by a government in desperate need of additional foreign exchange support rather than the adoption of a new strategy. During Mwinyi’s first term, policy positions adopted by government increasingly implied a new development philosophy, but this was not spelled out in a systematic fashion.

17 This conclusion is based on the personal observation of the author at that time—obviously not very scientific evidence. One indicator was the prevalence of a sort of ironic humor: black market prices were known as party prices; when questioned during the NESP (National Economic Survival Program), the popular response was to claim to be implementing PESP (Personal Economic Survival Program); the importance of “technical know-who” in acquiring scarce commodities was emphasized. That all having been said, it is striking that even with the advent of multipartyism in 1993, and the growth of an increasingly critical and investigative press, it seems likely that the CCM could well continue to dominate national politics, at least through the 1995 national elections.
a formal commitment to the old "vision," even while in the process of dismantling the system that embodied it.

- The view of those who were fundamentally skeptical about the old system and were committed to a market-orientated, mixed economy—by the early 1980s, for example, most academic economists subscribed to that position, along with supporters of some of the new parties (perhaps Edwin Mtei, leader of Chadema, offers the most explicit support for privately based, market-oriented development). They would view the failures in the old system as inherent. Support for the market and private activity, however, does not necessarily imply unqualified support for a liberal economic system; industrialists support protection and indigenous businessmen seek support in strengthening their position with foreign and minority community business interests.

- There is also a radical perspective, which is deeply suspicious of the distributional and other social implications of liberalization, but at the same time is critical of the failures of the old system, particularly its failure to live up to its own rhetoric in relation to mass participation in the development process (it is sometimes forgotten that the most active criticisms of economic policy in Tanzania during the 1970s came from the left, from such writers as Coulson, Shivji, and von Freyhold).

One scenario for reform is for drastic political change to precede economic reform. This might appear the most propitious for success. The new political broom might be expected to sweep clean, and political change could generate a new "vision" of society to guide and justify changes and generate political momentum in support of changes that threaten vested interests. This is not what happened in Tanzania, nor is that necessarily a bad thing. Although a priori reasoning supports the virtue of combining perestroika with glasnost, experience in the CIS suggests that it may be quite difficult to fashion a new political system, while at the same time managing economic transition. An existing political leadership may be effective in carrying through a profound economic reform while maintaining its hegemony, although convoluted efforts may be required to imply ideological continuity. This might be described as the Asian (Chinese, or more recently, Vietnamese) model of transition, a model that allows the state apparatus to intervene to limit economic and social instability in the transitional process. The Tanzanian experience had some points of similarity with the Asian model: reform was carried through with substantial continuity of the political regime. Reform of the economic and social systems, however, was not primarily led by government initiative (see Van Arkadie 1989). The political authorities essentially responded to the initiatives of other actors in the economy who, in the face of a decade of deepening economic difficulty, adjusted their behavior and changed their roles. Economic change preceded policy reform—successful policy often involved the accommodation and orchestration of trends and initiatives from outside government.

Thus the political economy of reform was conditioned by the process of economic and social change provoked by the conditions of economic crisis. The first steps in the adjustment process in Tanzania were found in the survival strategies of the various actors in the economy—peasants, urban dwellers, businessmen, and the servants of the state itself—in the face of the breakdown of the existing order. State employees increasingly had to maintain their living standards

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18 In Vietnam, in the formulation of doi moi, the party went to great efforts to avoid a commitment to the market or a mixed economy, using instead the term “multisector” or a “multicomponent commodity economy.” See Ronnas and Sjoberg 1991.
through moonlighting or the pursuit of "informal" incomes, sometimes derived from the use of their public office. In a poorly functioning political and economic system, those requiring services from state institutions often found it easier to buy favors from functionaries than to press for a more general improvement in performance.

With mounting economic disequilibrium, by the beginning of the 1980s the economy had taken on many of the characteristics of a supply-constrained economy. Under conditions of extreme scarcity of foreign exchange, bureaucratic allocation determined the availability of inputs, and in principle most commodities were distributed to the end consumer under a rigid system of price controls rather than through a market-clearing price system. An irony of the period was that the materials allocation system of the early 1980s was developed not through the agency of a Tanzanian planning body, but through the allocations of import support by bilateral aid donors, who found themselves deciding whether toilet paper, textbooks, drugs, or soap would be available.

The government struggled with fiscal imbalances fueled by a cumulative spiral of decline. Efforts to control prices, including the exchange rate, led to diversion of income flows into the parallel economy, weakening the tax base. The erosion of the real salaries of public servants caused by tightening resource availability undermined the probity and effectiveness of tax administration, and further shrunk the revenue base. The persistence of fiscal and monetary instability was fed by the lack of effective instruments to tax the growing parallel economy and to exercise financial control over public enterprises.

With the decay of the system of government control, the informal rules of the game changed, and activities that had been minor became more central to the economy. Just prior to the implementation of the Economic Recovery Program, parallel activity competed with the official economy in importance in many sectors (see Maliyamkono and Bagachwa 1990). The parallel economy was a critical phenomenon, feeding on the failure of the old system and contributing to the genesis of the new. The market economy asserted itself through the agency of the parallel economy as the planning system decayed. The black marketeer, the criminal of the old system, can be seen as the hero of the new. The black market not only acted to break the old system, but also began to provide a working basis for a new system of distribution.

In analyzing this process, two kinds of parallel economic activity can be distinguished. Some activity was genuinely "parallel" to the official economy, made up of a circuit of activity totally separate from the official economy, such as small-scale agriculture and petty craft production. The failure to "capture" this activity in the official circuit reflected the weakness of the state apparatus and the unrealistic nature of ambitions to extend state controls (for example, over local trade in food), but had no particularly negative consequences for the internal working of state institutions. The thriving market in smuggled exports, which arose in response to an overvalued exchange rate, was more ambiguous in its effects. It subverted the operation of major policy instruments (such as foreign exchange controls) and eroded revenue. Other parallel activities were an outgrowth of the official system, ranging from black marketeering, where scarce products were sold under the counter above the official prices, to the diversion of state property to private uses. These activities might better be described as "orthogonal" to the official economy, in that they depended on using access to the state to generate

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19 Thus, before the reforms that ended the official NMC monopoly on grain trade, much of the trade, both internal and to neighboring economies, was in the hands of private grain traders.
private income and set in motion changes in the state system.

Breaking rules and the allocation of favors are usually necessary for any rigid bureaucratic system to operate. Survival in a supply-constrained economy depends as much on technical "know-who" as technical know-how. Nevertheless, black marketeering is often not only against the formal rules, but may also be socially undesirable when it subverts a system of distribution that, even if ineffective, provides the public with certain rights of access to scarce commodities. For the consumer in the queue, black marketeering, which diverts already limited official stocks to benefit privileged groups in the system, was unacceptable. The resulting cynicism in Tanzania led to the popular description of black market prices as "party prices" in the early 1980s. This provided a popular basis for official campaigns against black marketeers, but was also a step in the erosion of the system's authority.

By the beginning of the 1980s, the way the Tanzanian system operated was thus at increasing variance with the vision set out in the Arusha Declaration. The growing gap between the ideal and reality led to a loss of public support for that vision. Distress and cynicism about the operation of the system could either engender support for change (substitution of one vision for another) or support a reassertion of the values of the system to bring ideals and reality into closer proximity. It was not unknown to find both these positions held by the same person, as a contradictory response to difficult times.

The genesis of market activity in the parallel economy leaves a negative legacy. The weakening of the morale and probity of public servants may erode the capacity of the state to undertake the tasks allocated to it in the reformed economy, while the experience of black markets generates unfortunate business ethics for the emerging market system. While parallel economic activity may make a positive contribution to the transition, it also involves a disrespect for the law, giving rise to a pattern of individual behavior that carries over into the reformed system a disregard for the legal requirements of business and a disrespect for normal fiscal obligations (for example, in Tanzania, lessons learned in avoiding the exchange control system have been readily applied to customs avoidance and manipulation of reimbursement of import support allocations). Businessmen became wise in the avoidance of all forms of government controls and impositions, which were implemented with increasing feebleness by a decaying state apparatus. The resurgence of private economic activity thus did not resolve the fiscal crisis.

The weakness of the negative political reaction that followed liberalization is consistent with the view that liberalization essentially accommodated changes already under way in the economy. Even before the implementation of substantial measures, support for reforms was evident among the bureaucracy and technocrats. University economists, for example, became increasingly open in their support of the need for liberalization, and there was widespread recognition that something would have to be done to improve parastatal performance. Why, then, was the government's opposition to liberalization so persistent? Some of the opposition to se-

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20 In 1983, when the Tanzanian economy was in the depths of crisis, the campaign against the walanguci (black marketeers) virtually closed down the economy in some parts of the country, because by then the parallel economy was the only effective marketing system in many parts of the country, but the campaign was initially quite popular. Similarly, in the early stages of Soviet reform, there was a strong popular distrust of the "mafia," which somewhat surprisingly seemed to be shared by Western donors, who claimed to be taking steps to ensure that aid went through "proper" channels to the "right" destinations.

21 And, of course, there is no way of determining the depth of support and understanding of the Nyerere philosophy among the mass of the population. Most observers agreed that there was widespread support both for him as a leader and for the ruling party; indeed, in the context of multipartyism, CCM still appears to enjoy the hegemony of the political system.
lected reforms seemed to involve a degree of misunderstanding. In a number of public statements, President Nyerere argued that devaluation would make imports dearer—that the exchange rate would have a significant impact on the external terms of trade. Resistance to change also had an idealistic element.

The Arusha model was intended to create a more equitable development pattern through politically determined distribution of income and property. Critics of liberalization have compared conditions following liberalization either with those prior to the crisis or to an idealized view of what the system was intended to deliver, rather than the reality of 1983 under the full impact of economic crisis and the failure of the system to respond when practice fell far short of the ideal. But before the full impact of crisis, the system was progressing toward some of its goals, and it is perfectly understandable that the architect of that vision should remain committed to it. Liberalization involved much more than the adjustment of economic policy instruments, because it set in motion a process that would lead to the dismantling of the system, so that opposition to liberalization was a rational response for those who remained committed to the socialist ideal, just as support for liberalization was a rational choice for those who wished to have done with that particular vision of Tanzania’s future.

There were interests as well as ideals at stake. As the economic crisis deepened, the parastatal sector became increasingly dependent on privileged access to resources. These privileges involved monopolies in internal markets and external trade; subsidies; and privileged access to scarce foreign exchange, donor import support, and credit from the state-owned banking system. Liberalization inevitably eroded these privileges and placed in question the sustainability of the parastatals and the positions of parastatal managers, whose perquisites often liberally supplemented austere formal salary scales.

The most obvious beneficiaries of liberalization have been those able to take advantage of trading opportunities in expanding free markets, and the most obvious losers were those who benefited from privileged access to scarce, state-controlled commodities and undervalued foreign exchange. In some cases, however, these were the same people. Given that those most subject to a relative loss in income as a result of reform were in the state apparatus, and traders and rural producers who were potential gainers were not effectively organized politically, the pressure for structural adjustment generally came from donors, although large segments of the Tanzanian population gained from reform. Only a minority of the workforce was employed by the government or in public enterprises. Much of the economy retained non-proletarianized, rural, labor surplus characteristics. Insofar as the unreformed system benefited those in official employment, it was supporting a small minority. This contrasted with Eastern Europe, where there was full employment, almost entirely in the state system.

The Reform Process

Resistance to Change and First Steps to Reform: 1979–84

Faced with a renewed crisis, over the period 1979–84 the government of Tanzania attempted a number of solutions before moving decisively in the direction of liberalization in the budget of 1984. In 1979 the government had agreed to a standby arrangement with the IMF to alleviate internal and external imbalances. A second standby agreement in 1980 fell apart when targets were not met. The government went public in rejecting proposals set forth by the IMF, setting in motion an extended period of acrimonious relations with
the Fund. Despite frequent and protracted negotiations, no further agreement was reached with the IMF until 1986.

When it failed to agree to a Fund program, the government attempted to reassert control over the economy and promote exports through bureaucratic means and exhortation, without adjusting the exchange rate, particularly under the National Economic Survival Program (NESP), 1980–82. Targets were not met. Exports stagnated and external assistance declined, so that the import squeeze tightened. Deterioration in the fiscal balance became increasingly alarming as the government defended the existing exchange rate and controlled price structure through subsidies, while losing revenues through increased income generation in the parallel economy.

In 1981 the World Bank funded the Tanzania Advisory Group (TAG) to provide assistance to the government in framing a structural adjustment program. The Structural Adjustment Program, which was adopted in late 1982, included steps to restore macroeconomic balance, improve incentives, and move toward liberalization. Commitments were made to improve incentives to producers of export crops, reduce the government deficit and the growth in the money supply, reduce imbalances by shifting resources from public investment to recurrent uses, and improve the efficiency of parastatals. Some steps were taken that involved difficult choices: for example, stopping implementation of a number of important investment projects. Some modest steps were taken in the direction of liberalization, such as internal food trade and private transport. Nevertheless, the government was unwilling to adjust the exchange rate significantly. TAG had proposed a devaluation that was considerably less than the amount the IMF was seeking, but still more than the government was willing to accept. Moreover, in important areas such as parastatal reform, the program was little more than a statement of intent. The macroeconomic targets in the program were predicated on its acceptance by the donor community, resulting in increased external finance and a shift in donor funding from project to import support.

Although there was a continuing shift in the composition of aid, with the balance shifting toward import support, and some improvement in the fiscal balance, the program did not prove acceptable to the IMF and the World Bank. Unlike the mid-1970s, this time the required increase in external funding did not materialize. Nor was the program sufficient to turn the economy around without such funding. Although the steep decline in agricultural output bottomed out, the collapse in industrial output continued, and there was a further deterioration in export performance. In these areas, the TAG exercise failed, but it did place a number of crucial issues on the internal agenda of government policy debate, including exchange rate adjustment and parastatal reform, and it sustained a positive dialogue between the Tanzanian government and part of the donor community, which became an important part of the process leading to reform.

Along with the Structural Adjustment Program, the government introduced a New National Agricultural Policy in 1982 (see Tanzania 1983),

22 Some aspects of the deterioration in relations between the IMF and Tanzania are in the public record. For example, the planning minister set out the IMF proposals and the government’s response in the Bunge (see Van Arkadie 1983). Other aspects were not made public. There was, for example, an unfortunately abrasive meeting between President Nyerere and an IMF delegation, which led to a change of leadership of the IMF team, and a change of Finance Minister, Mr. Mtei. Edwin Mtei, who was later nominated as executive director of the IMF and is now leader of an opposition party, Chama, has since made it clear that he supported the IMF proposals.

23 Ambassador Michanek made great efforts to keep the dialogue alive, particularly with the Nordic countries. Of course, it can (and has) been argued that the sympathetic stance adopted by the Nordics may have postponed reforms that might have been imposed by a more united donor stand in support of tough conditionality. Against that view, the Nordic governments took great care to make clear to the Tanzanian government that they were unprepared to provide an alternative to the multilaterals and that it was essential
which affirmed a commitment to improved agricultural incentives, restored agricultural cooperatives, reduced the role of the crop authorities, made a commitment to increase investment in agriculture, encouraged an expanded role for large-scale private agriculture, and accepted the role of the traditional local food trade.

At the top of the political system, however, there was strong resistance to devaluation and liberalization of the trading system. The ambivalence concerning the modest steps toward liberalization was demonstrated when an intensive— if brief—national campaign was launched against the walunguzi (black marketers) in early 1983. This campaign was supervised by the late Prime Minister Sokoine. It would appear that it was not so much that he was committed to the regulatory structure (soon after he was associated with pragmatic steps in the direction of liberalization) as he was alarmed by the lack of discipline and the cynicism associated with the widespread subversion of the law. In retrospect, the 1983 campaign can be seen as the last major effort to reassert control over the growing parallel economy. The futility of the effort was demonstrated in parts of the country such as Kagera, where the campaign was implemented with particular vigor, and it became evident that to close down the parallel economy was to close down the economy itself.24 It was in 1983 that economic difficulties in Tanzania became most extreme. Goods disappeared from the markets and there was a lack of commodities in agricultural areas, rendering financial incentives almost irrelevant.

Even if efforts to rein in the parallel economy had some temporary impact, vigorous growth in the parallel economy continued, and, as became evident later, this included the growth in exports bypassing the official system. This grew from the government’s unwillingness to make sufficient price adjustments. Although government would boost farm prices, it maintained price controls, was unwilling to adjust other prices, and made only minor adjustments to the exchange rate. The gap between official prices and parallel prices (including foreign exchange) widened, increasing the incentive to trade in parallel markets.

Under conditions of foreign exchange scarcity, and given the priorities of the official foreign exchange allocation system, there was a virtual famine of consumer goods in Tanzania by the early 1980s. Faced with extreme shortages of commodities, which placed tight limits on consumption and made it increasingly difficult to operate any productive enterprise that lacked access to donor commodity support, the government had to seek ad hoc solutions to its problems. One such step was to allow those with access to foreign exchange to import pick-up vehicles without having to channel their funds through the rigid exchange control system. It was hoped that this measure would alleviate the severe transport constraint the economy faced. This was successful, and it became a harbinger of the future pattern of liberalization.

In the past, the development strategy had been inward-looking and exports were discouraged by weak incentives, although autarky was neither attempted nor achieved. There was a decline in international trade because of the balance of payments crisis, and this had a severe effect on an economy still structurally dependent on imports. It was recognized that there was an increasingly difficult structural problem in the country’s balance of payments (developed in Green, Rwegasira, and Van Arkadie 1980). Exports financed too few imports to fuel the ambitious investment program and provide the imported in-

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24 It was at this time I heard that in my grandmother-in-law’s village, even salt disappeared, reflecting an extraordinary collapse in the trading system.
puts to utilize capacity. Nevertheless, exchange rate adjustment was not seen as an appropriate response at the time.

**Resistance to Exchange Rate Adjustment**

Resistance to reform in the early 1980s was particularly notable in exchange rate policy, with strong resistance to IMF and World Bank advice regarding the need for substantial devaluation. This was such an important issue that it needs to be explored in some detail. While there would now probably be a broad consensus that the failure to adjust exchange rates in the mid-1970s was a bad mistake, it might be useful to understand some of the reasoning and historical background behind the resistance.25

During the days of the East African Currency Board, currency in circulation had been adjusted in response to fluctuations in external reserves, with only a very conservative provision for a fiduciary issue. In an era of fixed exchange rates (the 1967 sterling devaluation was only the second sterling-dollar adjustment since the Second World War, the first being the Cripps devaluation of 1949), the Currency Board system underwrote the stability of the external exchange rate by its conservative, quasi-gold standard monetary policy. International orthodoxy leaned in the direction of fixed exchange rates until the dollar crisis of 1971. Even in the early years of central banking, monetary policy was cautious, inflation modest, and the exchange rate not obviously out of line with purchasing power parity.26 Indeed, except for the discussion regarding the appropriate response to the 1967 sterling devaluation, exchange rate policy had not been a feature of the East African policy debate. The kinds of issues that traditionally concern the IMF were not a source of policy controversy for some time, as evidenced by the benign relationship between the IMF and Tanzania, even during the period when Tanzania had access to IMF facilities following the first oil shock.

The case for not pursuing a flexible exchange rate policy in the Tanzanian context went as follows:

- Tanzania was a price-taker in most export and import markets, so that external terms of trade were not influenced by the shilling exchange rate; exchange rate adjustment would only affect internal relative prices.
- The internal prices of most export crops were set administratively, so that in principle incentives could be adjusted selectively, increasing prices for commodities with a good expected supply response without generating windfall gains to exports with a more inelastic supply.
- Government was implementing a prices and incomes policy to restrain inflation, which would be difficult to maintain in the face of large exchange rate adjustments (and if inflation were not restrained, the impact of exchange rate adjustment on relative prices would quickly erode).27

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25 There is obviously an element of self-justification at this point, as in the role of economic adviser to the Planning Ministry in 1967, the author of this essay was party to the analysis that concluded that the East African currencies should not follow the sterling in devaluing against the dollar, and in so doing helped develop a line of argument that supported a fixed exchange policy throughout the 1970s. The case that resulting weaknesses in the incentive system were an important contributory cause of poor export performance is presented by Jennifer Sharpley (1985).

26 The potential for this to change with the creation of national central banks was obvious (see Van Arkadie 1965).

27 The case against the use of exchange rate adjustment was later carried one step further by Ajit Singh, during the debate over the Structural Adjustment Program in 1982. In his usual persuasive style, he argued that export supply was likely to be largely price inelastic and it would probably be very difficult to adjust the real wage rate through exchange rate adjustment. Apart from any detailed weaknesses in Ajit Singh’s position, the overall flaw is that it implied that the existing exchange rate would always be the best of all possible exchange rates, and there was a strong a priori case for not making any use of a key macroeconomic policy instrument.
The two crucial assumptions implicit in this line of argument were that the government had the means available and the willingness to use them to fine-tune the internal incentive structure without using exchange rate adjustments, and that excess demand in the foreign exchange market could be handled by rationing (that is, exchange controls) without significant loss of efficiency. It became increasingly evident, however, that the apparatus of public agricultural marketing was not a policy instrument that could fine-tune anything, and the weight of its inefficiency was a prime cause of the erosion of incentives.\footnote{Credit for initially making the public case regarding the weaknesses of the agricultural marketing system must go to Frank Ellis, who produced a series of careful studies of the operation of the crop authorities at the Economic Research Bureau, University of Dar es Salaam (see Ellis 1982, 1983).}

The monopoly position of the crop authorities (and of single-channel marketing in its various manifestations) meant that both peasant and government lacked alternatives; the peasant had to sell through the single official channel (or smuggle), while the government had to fund its continuing operation, however inefficient, or countenance a disruption in crop marketing. As a result, the vast sums transferred from the government budget and the banking system to the crop marketing system—justified as a means of sustaining incentives—did little to improve farm prices, but instead disappeared into a bureaucratic black hole.

Although in retrospect it is clear that the failure to adjust the exchange rate and other market variables had severe political as well as economic costs, the use of administrative means to control the economy was sustainable as long as the degree of disequilibrium was not too large. This meant that foreign exchange available for allocation was sufficient to sustain a reasonable level of capacity utilization; goods were available in sufficient quantities to distribute under price control without provoking a generalized black market; and subsidization of parastatals could be handled without fueling excessive inflationary pressures. By 1981 those conditions no longer held. As disequilibrium increased, parallel markets in foreign exchange and imported commodities developed, and individuals and institutions with access to foreign exchange at the official rate were able to reap increasingly generous rents. This, of course, led to the development of strong interests within the government and parastatals in the maintenance of an overvalued exchange rate.

**The Reform Process: 1984–93**

Two years before agreement on the Economic Recovery Program with the IMF and the World Bank, the government began to explore its own route to reform. In the 1984 budget a series of measures were introduced that incorporated an important shift in policy. Steps included:

- import liberalization through an “own account” import provision
- reduction of the number of items covered by price controls, especially imported items
- removal of food subsidies, increased liberalization of food markets, and rationalization of the food marketing price structure
- the removal of agricultural input subsidies and the reflection of the new level of input costs in producer prices
- an enhanced commitment to defend the real level of agricultural prices
- first steps in cost-sharing in the social services.

The most important of these measures in immediate economic impact was the “own account” import scheme (see Tanzanian Economic Trends 1988). The own account import provision allowed those with access to foreign exchange outside the official exchange control allocation system to use the funds to freely import a wide range of goods. The initial rationalization for this policy was that residents might have access to such funds from relatives abroad, from savings
while studying overseas, and from other similarly innocuous sources. The provisions had an immediate and strong impact on the import of incentive goods and transport equipment, significantly changing their availability in local markets. The size and persistence of the import flow funded in this way, which far exceeded anyone’s expectation, soon made it clear that the funds were being replenished from sources other than those initially envisaged—that is, from the flow of export earnings that were bypassing the official exchange control system. Own account imports were being funded by parallel market exports.\(^{29}\)

This measure was important for a number of reasons. First, it was of macroeconomic significance as an initial, and substantial, step in relaxing the import constraint that had throttled the economy. Second, it implicitly accepted a dual exchange rate, because transactions supported by this trade were at a parallel exchange rate. Third, it involved an implicit acceptance that there was a great deal of unofficial—and illegal—activity in the Tanzanian economy, which could make a positive contribution to economic performance if allowed to do so.

The change in the government’s policy stance, as exemplified in the 1984 budget, took place while President Nyerere was still in office. The steps toward reform could be seen as a pragmatic response to the need for action to revive an economy in deep crisis, recognizing the need for immediate measures to loosen the constraints on economic activity and the realistic recognition of the need to restore relations with the donor community, a need that became urgent with pressure from donors who had maintained support, but were becoming increasingly alarmed by the deterioration in the economy. The policy change did not represent a fundamental shift in the ideological stance of the government, and the top leadership was not entirely happy with the measures adopted. Indeed, Nyerere continued to express concern about the distributional implications of trade liberalization after he left government in 1985.

Whatever misgivings may have existed in government, once begun, liberalization gathered momentum swiftly and met with little resistance. This is not difficult to understand. The depth of the preceding crisis meant that by 1983 there was widespread hardship. The crisis was reaching such great proportions that even those protected by access to rents were being badly hit by the negative effects of the dislocation in the economy. Critical parts of the initial liberalization legalized activities that were already established, and these measures mainly had the effect of reducing petty harassments, such as roadblocks checking food movements, and increasing ease of access to commodities for the mass of consumers. There were, of course, objections voiced, comparing liberalized prices with the previous controlled prices, but the force of such criticism was diminished by the knowledge that in the preceding period many goods had either not been available at all, or were purchased by the end consumer at black market prices no lower than the new liberalized prices.

In 1985 Nyerere was succeeded by President Mwinyi, although he retained his position as chairman of the party during most of Mwinyi’s first term.\(^{30}\) It was under Mwinyi, therefore, that the Economic Recovery Program (July 1986 to June 1989) was adopted and agreement was reached for support with the IMF and World Bank.

\(^{29}\) Numerous efforts have been made to estimate the size of the parallel market foreign exchange earnings implied by the level of "own account" imports by those monitoring the economy (including Benno Ndula at the University of Dar es Salaam and Enrique Rueda Sabatier in the World Bank office). Given the nature of the activity, it was not directly observable, while even data on the import side were not very reliable. Nevertheless, it seems that figures for parallel market foreign exchange earnings spent on own account imports could well have been in the range of 70–90 percent of official, recorded export earnings!

\(^{30}\) A presidential term runs for five years, and under current provisions a president is limited to two terms in office. President Mwinyi therefore completes his period in office in 1995.
It is true that the movement toward the reform program was begun under Nyerere, and that even with the adoption of the reform program, the rhetoric of the party remained socialist. Nevertheless, Mwinyi sought to define his own image as more pragmatic than Nyerere, and as his administration proceeded, the socialist content of the government program diminished.

Under the Economic Recovery Program, in addition to heightened efforts to tighten the budget, a number of innovations were made in the direction of financial orthodoxy. Substantial and continuing adjustments were made to the official exchange rate, which significantly narrowed the gap between the official and parallel rates. Interest rate policy was radically adjusted, and the objectives of moving to positive real interest rates and tight ceilings were adopted for credit expansion. The price control system was further dismantled, and additional steps were taken to rationalize and liberalize the grain marketing system. Incentives for exports were enhanced. In the 1988 budget, import tariffs were simplified and rationalized.

In response to the program, there was a large expansion in external financial support, including two Fund programs, several sectoral adjustment credits from the World Bank, and an expansion of bilateral commitments, particularly from donors who had held off during the period in which there was no Fund program. Some measure of debt relief was offered under Paris Club auspices, although Tanzania remained heavily indebted, particularly to the World Bank, reflecting the generous but not very productive boom in World Bank finance in the 1970s. An important aspect of donor support was the considerable shift of funding from projects to balance of payments support. This had already begun under bilateral import support programs, which continued on an expanded basis, and beginning in the second year of the program there was support for the introduction of an Open General Licence System (OGL), which further increased the flexibility of the foreign exchange allocation system at the margin. The Economic Recovery Program was followed by an Economic and Social Action Program (ESAP), initiated in 1989, which incorporated measures to revive delivery capacity and extend user charges (cost recovery) for social services.

The subsequent movement of policy toward continuing liberalization of the foreign exchange regime continued through expansion of the coverage of OGL, the disappearance of import controls, and the movement toward a unified exchange rate, which was achieved in 1993. There has been total liberalization of internal trade and nontraditional export trade, but much slower liberalization of traditional agricultural exports. Generous incentives were introduced for foreign investors. Price control has ended. Financial sector legislation has been enacted, opening up the banking system to private banks, and by 1993 the first private banks had opened. Donors have provided program support and substantial finance to rehabilitate basic infrastructure, particularly the road system, which had deteriorated badly.

This chapter is not primarily concerned with the economics of adjustment policies, and therefore discussion of the technical merits of the timing and dosage of particular economic measures is slight. Nevertheless, there are two elements of the interplay between the adjustment in economic instruments and institutional factors that require comment here.

In the early stages of the dialogue over reform, external advocates of orthodox economic
measures probably placed too much emphasis on the appropriate levels of the needed policy instruments, and too little emphasis on the institutional reforms necessary to make the instruments effective. Large adjustments in interest rates could not be expected to have great effect in a financial system (both banks and parastatal borrowers) not subject to a hard budget constraint. The level of official prices for the purchase of farm produce was not very meaningful to farmers who were subject to long delays in payment—or even non-payment—by ineffective marketing institutions. The notional price of foreign exchange allocated under import support programs was of limited interest to recipients of foreign exchange allocations who did not pay the local currency debt for the foreign exchange received. In all these cases, a change in the institutional arrangements to make the price system operational was a more important initial task than getting the notional prices "right."

A second general weakness was the failure to take account of the effect of economic adjustment measures on government performance. Insofar as exchange rate adjustment and other liberalization measures were intended to shift resources in the domestic economy from nontradables to tradables, the shift in incentives implied a reduction in the real wage bill for state employees. To the extent that liberalization measures made the activities of selected state employees redundant, that would be of no particular consequence. And, of course, if effective civil service reform were to be implemented, the decline in the real wage bill need not necessarily result in a commensurate decline in real wage levels if numbers in state employment were to be reduced. In practice, adjustment measures led to sharp declines in the real wage levels of public servants undertaking tasks necessary to the economy, and the failure to consider the implications of that decline was a glaring weakness in standard adjustment packages. Civil servants were no less sensitive to incentives than peasants (see Van Arkadie 1986).

**The Slow Pace of Parastatal Reform**

In contrast to the success in liberalizing the macroeconomic policy regime, reform of the parastatal sector moved slowly. Market reform requires not only that prices be right, but also that they be operative—that is, act as working constraints or incentives influencing actors in the economy. Realistic prices do not constrain enterprise behavior if the firm can avoid the consequences of losses (the soft budget constraint). The hard budget constraint is needed both to spur enterprise efficiency and to reinforce macroeconomic stabilization. The difficulty of imposing hard budget constraints at the early stages of the reform process was partly a question of political will. The soft budget reflected political unwillingness to enforce a harsh pace of adjustment, and the government was either a lazy shareholder or gave higher priority to objectives other than enterprise efficiency. In areas where there was a public sector monopoly, such as crop marketing, the government had to consider the impact of a parastatal collapse on the users of its services.

The situation was improved by two reinforcing movements. Over a decade, the monopoly position of the parastatals was dismantled. This began, as did most steps in the reform process, as a tentative and pragmatic response to changes already under way in the economy. The legalization of private trade in food and private urban passenger transport accommodated changes already in progress. The "own accounts" import provision eroded the parastatal dominance of the import trade. The success of private trade and transport in easing the extreme scarcities from 1985 onward made these changes popular and quickly created new interest groups in the private trading sector.

The other source of change was the external pressure on the government to improve the fiscal balance and to impose monetary constraint. Under donor pressure, beginning in 1985 the government moved to reduce budgetary subventions to the parastatals, but financial discipline was
cushioned by access to other sources of finance. For example, when budgetary support was withdrawn from agricultural marketing institutions, it was quickly replaced by credits from the state-owned banking system, which was not subject to effective financial discipline, but was open to political pressures. Public enterprises were financed through growing interenterprise debts. And in the absence of a strong assertion of ownership interest, wage and salary bills were in some cases met by cannibalizing the real assets of enterprises.

A slow pace of change was particularly evident in dismantling the single-channel monopolies in trading export crops. The slowness of reform in this area is somewhat surprising. The weakness of the marketing system was well documented and reform was presumably in the interest of the largest single economic group in Tanzania, the small farmers. Nevertheless, there were strong bureaucratic interests embedded in the marketing system, both at the national level, in the marketing boards, and at the regional and local level, in the reconstituted cooperatives. For example, in the cotton zone, the cooperative union had a clear interest in maintaining the monopoly position of the union-owned cotton ginneries. Moreover, the ending of the single-channel marketing monopoly was not placed very high on the agenda of donor conditionality in the first round of structural adjustment lending. Major steps in the introduction of competitive marketing in traditional agricultural exports were therefore delayed until late in the reform process. It was substantially implemented in 1994, but only after most other aspects of the international trade and payments regime were fully liberalized.

The difficulty of enforcing discipline on public enterprises provides the strongest argument for privatization. Privatization in Tanzania has been accepted as an objective, but implementation has been very slow, partly because of opposition from vested interests in the parastatals. An additional political difficulty resides in the limited supply of large-scale indigenous entrepreneurs. There is a weak national large-scale private sector, too poorly developed to take over large-scale public enterprises en masse. Although there are now many successful African businessmen, few have the experience and capital to take over a large parastatal. The wholesale transfer of public assets to foreign or minority community ownership could prove politically controversial; the desire to reduce foreign and minority community dominance of the economy explained much of the popular support for public sector expansion (see Van Arkadie 1973), the expansion of the state enterprise sector reflecting an aspiration to increase national involvement in the large-scale economic activity rather than a doctrinaire commitment to public ownership as such. The fast growth of Asian and Arab mercantile activities under liberalization, and the implications of planned privatization, have led to a provocative debate about “indigenization,” involving aspiring African capitalists and newly emerging political groupings in the mobilization of popular sentiment against restoration of economic power to minority communities.

Another difficulty is coming to terms with past investment mistakes. Many parastatals have little potential value as going concerns in a liberalized economy. They are often burdened with a heavy, foreign-exchange-denominated debt. While a reasonable economic case could be made that assets would be better transferred at a realistic market value—often liquidation value—so that they could be put to some alternative, productive use, public suspicion of sales greatly below historical costs is understandable.

Although the pace of privatization has been slow, the urgency of privatization in many sectors has diminished as the liberalization process

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32 Currently there has been some acceleration in the process through the mechanism of the liquidation of the assets of firms in debt to public financial institutions through the agency of LART, set up to carry out that task under the financial sector reforms.
has opened previous state monopolies to competition. Indeed, in areas such as crop marketing, there would have been no gain from privatizing a parastatal as a monopoly, and as crop marketing has been liberalized, there is no particular harm in parastatal marketing institutions competing against private traders, providing they do not require subsidies to survive.

The Distributional Impact of Reform

Much of the international debate about structural adjustment has related to its distributional effects. The proponents of structural adjustment have had to respond to demands for a “human face” by exploring the “social dimensions of adjustment.” Loosely structured criticisms of the distributional impact of policy over the past decade are often based on a comparison between the distribution of welfare following reform and the situation before the onset of crisis (the mid-1970s) or the intended result of the Arusha strategy. Arguments that the poor have suffered are often based on the decline in real earnings of the employed labor force since the mid-1970s.

The short-term impact of reform on income distribution includes the following:

- Compared with the situation before the introduction of the first reform measures (1983), the majority are probably better off, particularly in light of the great hardships experienced by almost all strata of society in the depths of the crisis.
- Some income groups that suffered a severe decline in real income during the crisis have not done well during the reform period, particularly the formally employed. Their decline, however, was as much as result of crisis as of subsequent reform. Also, the formally employed were not among the lowest income groups. A decline in their incomes cannot be presented as an income loss for the particularly vulnerable. Groups that most obviously lost out from reform include those who had been able to defend their real income under conditions of crisis through privileged access to officially allocated resources.
- There is some evidence in the GDP figures that there was a general shift in the internal terms of trade in favor of agriculture, which may be seen as an egalitarian shift.
- The period of crisis and reform has provided the setting for fast accumulation on the part of an emerging property-owning class, which is creating a society with much more evident inequality, but not necessarily greater poverty.
- The decline of the capacity of government to deliver social services, a result of both crisis and adjustment, has reduced coverage, which has had a differentially greater impact on the less privileged.

The crisis and the reform process resulted not only in changes in cash incomes, but also in the whole system of social service entitlements. An effort had been made to provide basic social services on a universal basis, but as an incomplete and underfinanced social service delivery system became strained, and even before reforms were introduced, access became differentiated on the basis of position in the system and income (for example, state employees began to demand payment for services that were, in principle, free). There has been a shift in public policy from free universal provision to cost recovery (user charges), which represents a significant shift from earlier ideology, but perhaps not so significant in its effects in light of the system’s decline.

During the period of great scarcity in Tanzania in the early 1980s, access to commodities at official prices was an important source of bene-
In government service and parastatals, as wages were strictly controlled, fringe benefits (such as housing, transport, entertainment, and international travel) became increasingly important determinants of real income. It was through differential nonmarket entitlements that the greatest inequalities in the system emerged by the end of the 1970s. Losses in real income among groups in the public sector came as much from declines in privileged access to scarce commodities as from loss of salary (while those currently enjoying high incomes from public service have done so through access to perquisites of office, including allowances to senior officials, rather than from salaries).

One difficulty in assessing welfare changes during crisis and adjustment is that the strategies of actors in the economy change. It tells little about the real income of university teachers, for example, to note that real salaries have collapsed if the teachers have changed their own strategies by taking on all manner of new income-generating activities. Perhaps the most important impact of crisis and adjustment is the degree to which many Tanzanians have been forced to adopt new strategies of economic survival.

This has had both a negative (where people have been forced to great efforts to make a precarious and bare subsistence in the urban informal sector) and a positive side (where pressures for economic survival have uncovered entrepreneurial talents).

There have also been changes in the flow of private transfers through the extended family system. In the 1960s, transfers from public servants contributed through the extended family network to the welfare of those outside the official system. By the 1980s the bureaucracy had to seek sustenance in informal activities, and urban dwellers sought to supplement their incomes from the countryside.

Evaluation of the distributional impact of reform must also address the long-run consequences of the change in economic system. The Arusha strategy had included an explicit commitment to egalitarian income distribution, opposed the growth of an African capitalist class, and embraced a "basic needs" strategy for the provision of social services. For those who feel that such goals were desirable and potentially achievable, the systemic change introduced through reform must be a source of disquiet.

**Sustainability of the Reform Process**

**The Momentum of Economic Growth**

The achievements of the economic reform program so far have included a revitalization of private economic activity, as domestic actors in the economy have responded to new market opportunities. The positive response has been greater than suggested by conventional GDP data, which incorporate most of the official, public sector economy and underestimate the unofficial, private (often informal) economy. As it is the official economy that has borne the brunt of stabilization, and the private economy that has been the main beneficiary of liberalization, the GDP data have a downward bias in measuring recovery under structural adjustment.33

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33 The official GDP data suggest that there was positive GDP growth from 1986, but still at less than 1 percent per capita annually. Because of the manner in which comparative GDP is recorded in the World Development Report, Tanzania's relative position in the GDP table has declined as the economy has progressed, so that it is now recorded as having the second lowest GDP of the nations included. This is entirely the effect of exchange rate adjustments, although it is reported in the Dar es Salaam press as evidence of the failure of the reform program! (See Van Arkadie and Komba 1992.)
It seems unlikely that the reform program has had a negative impact on the poor. The real deterioration in the incomes of many of the poor were as much the result of the crisis that gave rise to the need for policy change as the structural adjustment policies as such. If anything, the policies have a pro-rural bias, and hit the formal incomes of the urban middle class particularly hard. Policy reforms have received more widespread popular acceptance than politicians expected, although there has been understandable public suspicion of some measures.

Despite these successes of reform, the hard economic benefits achieved so far have been less than projected (see Ratso 1991 for a negative assessment of Tanzanian economic performance under structural adjustment). A certain fatigue can be observed in Tanzania, both on the part of government and the donor community, because the economic results of policy reform have fallen short of expectations. If, on the positive side, evidence can be offered that the reform medicine is working, and a near moribund economy is showing signs of life, the recovery thus far is less than complete. The modest success achieved looks impressive against the sorry background of the depths to which the economy had sunk, but although markets are working and the life of many—but certainly not all—is improving, it is not yet evident that the material and institutional basis has been laid for sustained growth over the longer term. While there has been widespread revitalization of the private economy, partly as a consequence of deregulation and the liberalized trade and payments regimes, it is still unclear that the conditions exist to support a sustained high rate of growth, and the economy remains too dependent on aid.

One question mark about the impact of reform relates to export performance, at least as measured by official data. This is partly a result of the deplorable state of the world markets for leading traditional exports; continuing vulnerability to fluctuations in markets for a few traditional crops, however, demonstrates continuing structural weakness, a problem that has yet to be solved. The assault on “inward-looking” trade policies is often supported by appeals to examples of successful export-led growth in East Asia. The success of the Asian tigers was based on dynamic adjustment of their comparative advantage, however, whereas the export trade of Africa continues to concentrate on traditional commodity markets.

In the period preceding structural adjustment, government interventions to alter the location of Tanzania in the international division of labor were signally unsuccessful. Under structural adjustment, diversification into new export areas has made a small beginning, but performance of recorded nontraditional exports has done no more than restore volumes to 1980 levels. There is considerable unrecorded export trade—for example, the artisanal mining sector, which produces gold and precious stones, exports much of its output without it being recorded in official data. There is a diversified cross-border trade in consumer goods, including food, which is also only partially recorded. Efforts to estimate the magnitude of unrecorded exports—for example, based on estimates of the financing requirements for recorded imports—suggest that unrecorded exports could

34 Although as this paper is being prepared, Tanzania seems to be facing the prospect of improved markets, because the price of coffee escalated in the early months of 1994.

35 Official export data show stagnation throughout the 1980s and up to 1992, with year-to-year fluctuations but no clear trend. As the discussion of parallel markets and the foreign exchange system noted, however, there has been a significant undercounting of exports. Whether the undercounted total has grown significantly is unknown. With the unification of exchange rates and a fully liberalized trade and payments regime now operative, a higher proportion of exports should flow through channels captured in the official statistics.
equal official recorded exports. If that is so, Tanzania’s recovery may well be much more robust than impressions based on official data suggest. This is highly speculative, however. Even if it can be inferred that unrecorded exports are considerable, no one has yet been able to estimate a growth rate.

In the absence of hard data, it is reasonable to question whether a plausible vision exists of how Tanzania can earn its way in international markets. Even if market stimulus is a necessary ingredient for economic success, it is far from obvious that it will be sufficient to generate the export growth to fund Tanzania’s increasing import and debt servicing requirements. The response to new economic opportunities by actors in the economy has been significant, and given time this may have a cumulative impact on economic performance and provide the institutional basis for export diversification, but there is little hard evidence of the magnitude of the growth impetus that this will sustain over the medium term. Moreover, part of the improvement that can be observed has been at least partially the result of a self-fulfilling donor hypothesis: policy reform is necessary, therefore increased donor support is conditional on reform, but increased support following reform itself results in improved performance. Thus, output revival may have been as much a result of aid increases as the positive impact of policy reform.

Since the adoption of the Economic Recovery Program, Tanzania has achieved positive growth in per capita income, probably at rates higher than suggested by official GDP data, which undercount informal and private economic activities. Nevertheless, both the Tanzanian population and the donor community tend to perceive growth as sluggish. It may be difficult to sustain the vision of market-orientated development in the absence of a clearer breakthrough into higher growth, particularly in the absence of the powerful inspiration of other African success stories. For the economist, a Panglossian view that the free market provides the best of all possible worlds may be sufficient. For others, that may be less persuasive, particularly if the memory of the economic difficulties faced under the old regime in the early 1980s fades, and the ideals espoused in the Arusha Declaration revive. In the longer term, it is likely to be necessary for government to again address issues of economic structural change, learning lessons from the failures of the earlier efforts of 1960s and 1970s, but seeking out a vision of change that is less passive than simple dependence on market forces.

The Managerial Capacity of the State

A continuing cause and result of economic crisis that structural adjustment policies have been unable to address is the erosion of the capacity of the state. The development of a market economy needs to be backed by reasonably strong state institutions to provide a stable macroeconomic setting and a supportive institutional environment and to offer the economic and social services that are necessarily the responsibility of the state. The recent concern about governance—for example, in the World Bank literature—includes an effort to spell out a vision of the state and its role in the reformed market economy. But the reform process as it has been experienced so far has done little to restore the capacity of the state.

36 See the combined issue of Tanzanian Economic Trends (vol. 5, nos. 3 and 4, Sept. 1992 and Jan. 1993), which is devoted to nontraditional exports. See, in particular, the article by Dik Bol.

37 In 1991 I took on the interesting assignment of accompanying a team of senior Vietnamese on a study tour of Malaysia and the Republic of Korea. The powerful impact of the economic success of economies in the same region was obvious. It is less persuasive to hold up the image of Asian success as an inspiration to an African audience, but this is what proponents of market reform find themselves doing.
One of the main thrusts of structural adjustment has been to prune the economic tasks undertaken by the state. The removal of exchange controls, price controls, and the reduction in all sorts of state intervention have dramatically reduced state tasks. These reforms attempted to confront the reality of an enfeebled state apparatus that was increasingly unable to enforce its rules and regulations. Economic reform has narrowed the range of government intervention and should have left government with a more manageable set of tasks. Yet as private economic activity has revived, it has become increasingly clear that the state no longer has the capacity to undertake the basic tasks necessary to support the private economy. The expanding private economy faces constraints because of the inadequate provision of services that remain the responsibility of the public sector. Where economic infrastructure has been rehabilitated, it has been the result of donor support.

Adjustment policies could have contributed to the enfeeblement of state institutions. Exchange rate and budgetary adjustments were intended to shift income to the tradeable goods sectors and away from the state bureaucracy, both in nominal income and access to rents. The shift in the internal terms of trade in favor of the private sector and the rural economy involved some loss of privilege for state functionaries, one reason for resistance to change. The availability of external support cushioned the impact, and increased imports allowed a general revival in living conditions, but the public service was left underpaid and poorly motivated. In recent years there has been an effort to restore the real incomes of senior civil servants, largely through enhancement of perquisites rather than by decompressing salary scales, but this has not affected the large mass of public servants.

The deterioration in the delivery of social services has persisted as a reflection of the stringent resource constraints and slow implementation of new strategies of delivery and cost recovery. Macroeconomic structural adjustment did nothing to improve the situation in the social sectors. While there is little evidence that structural adjustment had a regressive impact on the primary distribution of income, fiscal stringency has had a strong negative impact on the public provision of social services. Formulation of new sectoral strategies (for example, in the ESAP) has been partial, support for the social sectors has not been informed by a coherent strategy to promote institutional reform, and progress in implementing new strategies has been limited. In light of the fiscal debility of the central government, one way forward might be through local initiatives and control, either through local government or self-help, even though this feeds regional inequalities and might give local privileged groups greater control over access. Given the importance of investment in human capital, the continuing decay in education and health delivery systems may prove to be the most debilitating of the weaknesses currently observable over the long term.

The tasks left to government are not only critical, but also in some ways complex, including the manipulation of market-related policy instruments, the implementation of public investment programs, and the management of public infrastructure and the delivery of social services. The government needs to fill gaps in the institutional arrangements for the private economy, including modifying the legal framework in such areas as land law and corporate law; sponsoring the development of new markets, such as financial markets; and encouraging coordinating agencies, such as trade councils and chambers of commerce. There is little sign of restoration of government's ability to handle such essential tasks effectively.

Real salaries in the public service collapsed during the crisis and adjustment, and the performance of many employees precisely matches their vestigial incomes ("the government pretends to pay us, and we pretend to work"). Senior civil ser-
vants survive on the perquisites of office. The public investment that does take place is donor-financed, so that public investment planning is almost entirely a matter of donor coordination. It could be argued that what is required is nothing less than the reconstruction of the state. Even if an essentially private economy is the vision for the post-structural adjustment era, a more effective set of state institutions is required. The state needs to be reformed to be able to meet the needs of market-orientated development, including the provision of essential infrastructure and social services and, as the private sector grows, the implementation of appropriate public actions to accommodate and orchestrate private economic activity.

What is required is a more careful definition of the responsibilities of government in the emerging economic situation and a systematic effort to put in place a reformed bureaucratic structure to tackle the identified tasks. The agenda for the reconstruction of state institutions includes clarification of the required institutional structure, identification of appropriate manpower requirements, and the definition of an effective incentive system for the public service. In principle it is not particularly difficult to formulate a blueprint for reformed systems of government administration; in practice, however, very little gets done as the existing systems, for all their weaknesses, operate as a subsistence sector for large numbers of employees.

Civil service reform might result in fewer public servants, although concentrating attention on reductions in numbers has so far not proved a very effective reform strategy. This is partly because redundancy is expensive, so that there is little initial benefit from staff reduction, and because appeals to reduce the “bloated” civil service tend to oversimplify a complex set of problems. It is certainly the case that for some cadres employment has expanded well beyond need, and a reduction in numbers combined with an improvement in terms should be one strategy to improve performance. This is probably the case in a number of major economic management tasks of government that do not require large numbers to implement, but do require a certain minimal level of professional competence to perform effectively.

Much of the expansion in the Tanzanian public service, however, occurred through the increase in the number of schoolteachers (the largest group of public servants) and primary health care workers, as a consequence of the decision to expand the coverage of the education and health systems in the 1970s. In these cases, the reduction in the numbers employed would imply a decision to reduce the coverage provided; conversely, mass provision of such services will only be possible if the primary contact staff (primary schoolteachers and primary health care workers) are paid at levels that can be sustained by the population serviced, either through taxes or cost recovery. This suggests that important groups of public servants cannot be paid at levels out of line with the household incomes of the communities they serve.

In practice, public service incentives in Tanzania have been handled increasingly through the manipulation of nonwage perquisites, so that the differential in actual real incomes is much broader than the high degree of compression in formal salary scales. Perhaps more important than reducing total numbers of public employees—which tends to be achieved by shedding the lower-level employees who are ready to continue at the pitiful existing salaries, and are no great burden on the budget—is the need to create a more complex career and incentive structure that recognizes

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38 Although these may be sufficient to provide a reasonable income for top functionaries, a result of the process of using ad hoc mechanisms to shore up incentives is a lack of transparency regarding the system of remuneration operating in the civil service and the parastatals.
the needs of different groups of public servants and ensures that an essential core of senior public servants are looked after sufficiently well to attract the high-level staff and to motivate them. At all levels of the public service, however, commitment and morale are not just a matter of payment levels, but also a matter of the status and responsibility accorded to the service. One need in the Tanzanian system is to restore the level of commitment at many different levels of the public service.

One aspect of deterioration of governance in the reform period, which is by its nature difficult to document but widely perceived, has been the growth in corruption. Corrupt practices were unusual in the 1960s. Under the conditions of economic crisis in the 1970s, widespread petty corruption was associated with the development of the informal economy. During the period of economic reform, corruption is perceived to have spread to the higher levels of government. If economic policy emphasizes the market and accepts free-wheeling private accumulation, it is unclear how the political system can be insulated from the temptation to use political power as a base for private accumulation.

The Role of Donors

One change in the political economy of Tanzania in the 1970s was the rise in the importance of donors. It was during the first period of economic difficulty that donors—including the IMF and the World Bank—built up their support; total aid grew from US$100 million in 1973 to US$302 million in 1975 (see Havneik and others 1988, table 6.6). In the decade following 1973, Tanzania received around US$5 billion in aid (Havnevik and others 1988, table 6.6). This transformed the structure of the Tanzanian balance of payments, accommodating a large and persistent negative trade balance, in contrast to the 1960s when the trade balance was modestly positive. It was almost as though the adoption of self-reliance as a national goal was particularly attractive to donors, perversely resulting in a high degree of aid dependence! It also meant that with aid donors funding nearly half of the import bill, donors necessarily became important actors in the policymaking process.

Any discussion of the evolution of policy in Tanzania must thus address the role of donors. They have become important political actors. Major macroeconomic policies, such as exchange rate adjustment and fiscal and monetary policies, have fallen increasingly under the influence if not direction of the Bretton Woods institutions, and even at the level of project choice, design, and staffing, donor agencies have often played the leadership role.

The assertion of donor authority has occurred despite the rather weak evidence of donor competence. The record of disaster in the performance of aid projects in the 1970s almost matched the

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39 The accusations of corruption from the donor community have focused on the administration of foreign exchange program support (import support and the OGL scheme), and came to a head in 1994 with public accusations regarding the maladministration of revenue collection in the Treasury. This led to suspension of aid disbursements and changes in the leadership of the ministry. In 1994 and 1995, former President Nyerere launched devastating attacks on the probity of the government, including explicit accusations that the corruption spread to President Mwinyi's own family.

40 Whether all that aid was of much use is a legitimate question, given that after a decade of heavy aid flows, per capita incomes were probably lower. In a contribution to the most recent World Bank Country Economic Memorandum, I offered the judgment that at the margin, aid had negative productivity—certainly OED assessments have demonstrated that many World Bank projects in that period produced nothing, and they all had domestic costs (see Therkildsen 1988).
earlier debacle of the British Groundnut Scheme.\textsuperscript{41} Frankness at the level of operational evaluation of projects has not, however, led to any particular modesty on the donor side in claiming wisdom in policy formulation. Nor has donor failure been associated with any noticeable accountability.

Donors were slow to recognize weaknesses in Tanzanian economic performance. By the second half of the 1970s, critical performance indicators began to suggest that the system was in trouble—notably the decline in production of export commodities and slow completion of investment projects as limited resources were spread over far too many projects. Nevertheless, the system was not yet in open crisis and donor alarm was slow to manifest itself. The World Bank 1977 Basic Economic Report included a number of warnings. For example, it noted the operation of the parastatal sector and the possible highly negative macroeconomic scenarios, and it could be seen as a turning point in donor attitudes, but such warnings were still muted, and did not yet motivate harsh conditionalities.\textsuperscript{42} The Tanzanian government showed some flexibility in responding to advice from the World Bank to relax import controls. Unfortunately, this had a disastrous result. Imports surged in 1988, just as the coffee price boom came to an end and imports again had to be brought under tight control.

Donors not only participated in the dissipation of resources at the project level, but also contributed to systemic deterioration. Donor willingness to fund the development budget with little consideration for the sustainability of the recurrent spending requirements also added to the chronic deterioration in public expenditure management. Donors also contributed to the over-elaboration of the bureaucracy. New departments of government and parastatals were funded with little concern for their eventual sustainability, either in manpower or funding. The flow of technical assistance itself contributed to a cancerous proliferation of bureaucracy as development projects spawned new sorts of bureaus and government agencies. For economic planners, nothing succeeded so well as failure: the failure of macro planning led to the creation of sectoral and project planning units, failure at the center motivated the development of regional and district planning, and failures in aid implementation led to the creation of project implementation and monitoring units.

The global shift in donor thinking was as important as other exogenous factors in influencing the reform process. The World Bank signaled a much clearer commitment to the market with the publication of the Berg Report in 1980 (World Bank 1980).\textsuperscript{43} In influential Organization for Economic Cooperation and Development (OECD) capitals there was a more substantial ideological shift than at any time since the World War II (notably in Washington, with the advent of Reagan, and in London, under Mrs. Thatcher). The IMF

\textsuperscript{41} The record is documented in many frank operational evaluations, such as the World Bank's evaluation of such agricultural failures as the National Maize Programme, Geita Cotton, the cashew nut processing projects, and the like. Therkildsen (1988) has documented the failure of a number of agencies in supplying rural water supplies. The Morogoro Shoe Factory must be one of the worst disasters in the World Bank industrial portfolio.

\textsuperscript{42} It is difficult to pinpoint when donors moved over to a generally critical stance on Tanzanian policy. In the mid-1970s, when in retrospect it seems that problems were already building for Tanzania, the World Bank was financing projects in a manner that bordered on the reckless (the Second Cashew Nut, National Maize, Geita Cotton, and Morogoro Shoe Factory were among the failures that originated in that period). While the World Bank Basic Economic Memorandum of 1977 began to raise general issues of policy and strategy, the subsequent comment by the Bank itself on that report illustrates the limited scope of the criticism: "Though the BER threw light on linkages between 'real' aspects of the economy which the Bank had been dealing, and the macro and monetary aspects, the latter were still treated in a cursory fashion. Monetary and foreign exchange policy were virtually ignored. Replacement of quotas by tariffs was advocated to rationalize production, but it was not even mentioned that the proposed changes would have a positive effect on fiscal revenue" (World Bank 1990, p. 58).

\textsuperscript{43} This report is commonly know as the "Berg Report." The team that produced the report was led by Elliot Berg, who could claim a reasonable degree of consistency, because he had already been a critic of etatist development strategies in Africa in the mid-1960s.
was also less accommodating by the end of the 1970s than it had been when responding to the first oil shock under Witteven—although in the Tanzanian case, its unbending stance was in part the response to mishandling of negotiations, for which the Tanzanian government must bear some responsibility. By 1980, the donor community had shifted its stance significantly compared with the mid-1970s, and the Tanzanian leadership was possibly rather slow in picking up the change.

The donor community did not, however, present a united front. There was a virtually universal recognition that major reform was required, but a number of bilaterals were unwilling to shift from a supportive stance, seeking reforms through friendly dialogue rather than a more belligerent stance of hard conditionality. This was particularly true of the Nordic group and the Netherlands. Even inside the World Bank, there was an effort to hold off outright confrontation through the agency of the Tanzanian Advisory Group (TAG; 1981–82). In 1981, in an effort to encourage reforms and to avoid confrontation between the World Bank and the Tanzanian government, the Bank proposed and agreed to fund TAG. This was an independent team, funded by the Bank but acceptable to the Tanzanian government, that sought to mediate and find a reform package acceptable to the Tanzanian authorities that could form the basis for a new IMF/World Bank program. The three-member advisory group, agreed to jointly by the Bank and the government of Tanzania, was backed up by a small secretariat.44

TAG presented a report to the government of Tanzania that was partially incorporated into the Structural Adjustment Program. Whether the proposals of TAG—which included a significant devaluation, but still well short of the adjustments proposed by the IMF—would have provided the basis for an IMF program is in itself doubtful; the watered-down version accepted by government was not acceptable. The attempt to reach a compromise with the donor community therefore proved unsuccessful, and the Structural Adjustment Program (1982) did not provide an acceptable basis for an IMF/World Bank program.

Bilateral donors who maintained their programs during the period in which Tanzania did not reach agreement with the Bretton Woods institutions (1979–85) had to recognize that the main thrust of their support should no longer be directed to increasing the capital stock, but should instead provide the minimal resources required to sustain recurrent activity and to rehabilitate critical elements in the decaying infrastructure. The “like-minded” therefore found themselves in a holding operation, using their support to keep the economy going, while actively lobbying the Tanzanian authorities to reach agreement with the IMF and World Bank. Critics of the aid agencies within the like-minded countries have questioned whether the “soft” approach adopted did Tanzania a disservice, noting that reform might have happened sooner if the donors had presented a united front. Against this it can be argued that the Nordic group was able to act persuasively in encouraging the Tanzanian government to reform and that a total donor boycott would have had severe economic effects and quite unpredictable political consequences.

In the 1980s the euphemistically titled “aid dialogue” was finally successful in promoting policy reform. This proved effective in promoting devaluation and the shift to a more liberal payments and trade regime and reductions in budgetary subsidies to parastatals. Donor condi-

44 The Advisory Group was led by Ambassador Ernst Michanek, who had been the first head of SIDA. The other members were Professor Gerry Helleiner of the University of Toronto, who had been the first director of the Economic Research Bureau, University of Dar es Salaam, and Professor Cran Pratt, also of the University of Toronto, who had been first vice chancellor of the University of Dar es Salaam. The secretariat was led by the current author, and included Professor John Loxley, University of Manitoba; Rolf Hofmeier, University of Hamburg; and Peter Ngumbullu, now principal secretary to the Tanzanian Treasury.
tionality has been less successful in promoting other institutional reforms. In relation to reforms in agricultural marketing, where the objective should have been the straightforward end of single-channel marketing monopolies, the World Bank was surprisingly tentative in pushing conditions.

The liberalization of food marketing, which was a corollary to the withdrawal of subsidies to the National Milling Corporation, was carried through with remarkable success, partly because it involved the accommodation of an informal pattern of food trade that was already well established. The promotion of competition in the processing and trade of traditional export crops was much slower, and remains incomplete. Given that an early Bank structural loan was conditional on agricultural sector reform, it suggests that an opportunity was lost; compared with Fund conditionality, Bank program loans tend to carry more conditions of much less precision and strategic significance.

The Bank and Fund did not do very well in promoting financial sector reform following the completion of the Presidential Commission of Enquiry into Banking (the Nyaribu Report) in 1990. Swift progress should have been possible through decisive support for the implementation of the commission proposals. While no doubt imperfect, they were radical and comprehensive.

So far there has been little success in donor promotion of comprehensive public sector reform. The initial steps in structural adjustment involved changes in key macroeconomic policies and decisions to dismantle numerous government controls; as such, the programs were implemented by a small cadre of officials in the economic coordinating ministries and the Central Bank. Donor conditionality initially focused on a few macroeconomic policy instruments that could be readily monitored. Reform of the institutions of government is a more complex task, and donor promotion of such reform faces the contradiction that their own role has been one source of the erosion of governmental capacity. Even where piecemeal efforts to improve the performance of portions of the government have had some success, it has been at the expense of making the overall system more confused (for example, the provision of ad hoc donor incentives to public servants in priority aid areas, which render the overall incentive system even less coherent).

Administrative capacity was not enhanced by donors continuing with technical assistance approaches developed in the 1960s to handle a quite different set of problems, inserting highly paid foreign advisers or consultants into systems that suffered not from a lack of skilled nationals, but rather from an inability to utilize them effectively. This bred resentment and frustration on both sides.

Reform of government is most likely to be achieved by a process owned by and embedded in the national government structure, with the understanding and eventual support of the top political leadership and civil servants. Such United Nations programs as the Management Development Program (MDP) and National Capacity Assessment (Natcap) have addressed aspects of administrative reform, as did two World Bank public expenditure reviews and numerous bilateral technical assistance exercises. An effective donor strategy for promoting the required degree of reform in public administration has yet to be identified. Donors have promoted ceilings on public expenditures and employment, programs to ease the hardships of redeployed civil servants to soften opposition to reform, and piecemeal and uncoordinated interventions to bolster particular segments of the public service, but these initiatives have so far fallen short of an effective reform strategy.

Could donors do more to promote administrative reform? One problem may be that while the donor promotion of a market economy has been based on a plausible vision of the way the economy could operate more effectively, the accompanying vision of the way politics and the
administration should perform is less clear, or where it can be identified, it may be too Utopian to be of much practical significance. The vision of a small, well-paid, elitist public service led by an uncorrupt and committed political leadership has a striking similarity to the ideal of colonial administration. Added to that, however, is the desire that the system function as a multiparty democracy. While aspects of the internal logic of that vision can be defended as consistent—multiparty democracy might be expected to check the more flagrant forms of high-level corruption—there are also inconsistencies. Democratic politics in poor countries is unlikely to be supportive of an elitist administration (one component of the “good governance” package) and is likely to encourage patronage and an overexpanded civil service. Likewise, in a poor country, emphasis on the virtue of private accumulation can too easily lead those in positions of political authority to use their political power to participate in the accumulation process.

One way for donors to pursue their vision of better governance would be to seek to buy a more effective administration. Setting aside a significant proportion of funds currently devoted to technical assistance, consulting, and the like over a period of years to fund a new incentive structure for national professionals that could be introduced with reforms to improve working conditions could raise standards of performance. This would contrast with donor-sponsored attempts at reform so far, which have emphasized cuts in the public service without offering noticeable benefits to the remaining staff. Such a donor initiative would require modification of long-standing donor thinking limiting the role of aid in supporting local costs. Given the de facto contributions donors have been making to recurrent budgets through import support programs, this would primarily involve an effort to think through the logic of existing practice. Perhaps the most alarming implication of such proposals is that donors would be taken further down the road toward becoming the meaningful government.

The possible donor contribution, however, is likely to be limited. The effective organization of government is necessarily a national matter, and there is little evidence that donors have a comparative advantage in providing government services. Indeed, it is evident that pervasive donor intervention has become part of the problem, because it has undermined local initiative and accountability. The commitment of substantial resources by agencies such as the World Bank to the production of numerous highly elaborate mission reports seems to have only a sporadic impact on local policymaking, but it can serve to displace any national commitment to undertake serious policy analysis.

It is also difficult for donors to establish and maintain a realistic and internally consistent set of expectations. Donors have sponsored structural adjustment and have lectured on the limited capacity for successful government intervention in the economy. Yet it is the donors who press to add to the policy agenda items that require sophisticated interventions, such as targeting social groups that have suffered from structural adjustment policies. Having pressed for market economics, donors tend to be shocked by the realities of market relations in very poor economies. And having exulted multiparty politics, there is surprise that the emergent lines of political division are based on populist demagoguery rather than a measured discourse regarding policy. Therefore, in the face of the evidence that economic reform in Tanzania has been more of a success than most commentators and donors would have expected when the process started in the early 1980s, donors turn sour, infected by fatigue that reflects the failure to define realistic expectations and goals, and the short institutional memories characteristic of donor agencies.
A National Vision of Development?

The reform period in Tanzania has been associated with a blurring of political vision; perhaps it is best described as a period in which politics have become less important and political attitudes more cynical. Even the initiation of multiparty politics in Tanzania did not respond to any upsurge of political enthusiasm or unrest; the testing of opinion that preceded its introduction suggested that there was not majority support for abandoning the familiar one-party system.

The tentative and sometimes ambiguous ways in which a number of reforms have been introduced could be seen as resulting from weakness of leadership and failure of vision. It could also be argued that the movement away from the clearly defined vision of the Arusha Declaration and the accommodation of a process of change from below was well served by a politics that was low-key and rather nonideological. In the politics of the market economy, profits rather than prophets become the order of the day. That Tanzania has been able to experience profound economic and social changes with remarkably little tension and confrontation may in part be because of a politics that increasingly avoided issues of principle and ideological choice.

Economic reform came to Tanzania during a period in which a charismatic leader with a clearly defined vision of development retired, and his vision has not been replaced by a clearly defined alternative. Nyerere had eventually been willing to reform, and had often been willing to be self-critical about failings in the implementation of the Arusha vision, but he has never acknowledged that the economic crisis the system faced demonstrated inherent inadequacy of his socialist vision of the Tanzanian future. Since Nyerere, the tone of policy presentation has been pragmatic in character, and the ideological shift has been implicit, rather than being spelled out in a new political ideology.

Effective economic performance by the state is not only a matter of the quality of leadership and clarity of vision—the record shows that Tanzania got into economic difficulties with high-quality leadership endowed with a clear vision. Perhaps more important is the sort of pressure likely to come to bear on the state to influence its performance. Tanzanian politics is in a state of flux, and it is quite unclear how the economic groups strengthened under liberal economic policies will participate in the political process, how a lively ("vibrant" to use a favored World Bank term) small-scale sector and fledgling indigenous capitalists, operating through the new multiparty populist politics, will impinge on enfeebled state institutions.

The rhetoric of multipartyism (including that of the ruling party) leans toward supporting the virtues of good government and rooting out corruption. At the same time, there seems to be an increasing public perception of venality in the upper reaches of government, although how correct this perception is may be impossible to judge. Part of the current disquiet no doubt reflects the impact of an increasingly open, muckraking press. This suggests that there is a growing constituency for improved governance, which could

45 Such matters are difficult to assess. Certainly there were a large number of scandals and suggestions of scandal aired in the press during 1993, and the level of popular cynicism and anger in Dar es Salaam seems to have increased considerably. There is also a perception in the diplomatic community that the system has become more corrupt, which specifically focused on the operation of the allocation of foreign exchange under donor program support (the OGL) during 1992-93. It should be noted that the level of probity in the public service was at a high level in the 1960s and early 1970s. Behavior certainly deteriorated at the lower levels of the public service in the economic difficulties that emerged during the 1970s, when falling real incomes created the need, and a supply-constrained, malfunctioning system of control created the opportunities. There is now a widespread perception that dubious practices have penetrated the political hierarchy—a view articulated, for example, by Mr. Mrema, Deputy Prime Minister and Minister of Home Affairs, a populist spokesman in support of law, order, and honesty in public life.
result in the definition and implementation of a new vision of the role and management of government, possibly in the context of the elections of 1995, the first ever multiparty presidential and parliamentary elections in Tanzania.

If the reform process has been guided by a vision, it has been that of the international donor community. This is not to say that there has not been national support for reforms, but that acceptance has so far fallen short of the definition of a new set of clear national goals to replace those articulated in the Arusha Declaration. The vision of the donor community can be pieced together from numerous donor documents, particularly from the World Bank, which address elements of economic policy. It is probably not too far in the direction of parody to suggest that the recipe on offer is “take one teaspoonful each of free trade and private investment, plus a dram of property rights and the rule of law; and wash down with a swig of multiparty democracy” (Mortimer 1994). The donor vision is reflected not only in the reforms promoted by the World Bank and other agencies, but perhaps even more sharply in donor exasperation at the recalcitrance of the African pupils in not learning their lessons.

The vision of economies operating with undistorted commodity markets and freely flowing capital, with just social policies that deliver social services in an equitable manner, officiated by a multiparty political system, innocent of corruption and pure of purpose is an attractive Utopia, but is not particularly realistic. The lack of realism shows itself in the oscillations of donor concerns—the emphasis on the market followed by shock at the inequalities the market generates, the adulation of private business and the embarrassment at the processes whereby business classes emerge at the early stages of capitalism, and endorsement of multiparty politics and subsequent surprise that party politics is about the sectional competition for spoils.

The vision of welfare distribution associated with the adjustment process is far from clear. Advocates of the market tend to view the inequalities that emerge from an efficient market process as functionally justified, and they tend to believe that in freely operating labor markets and undistorted commodity markets, poor workers and peasants are likely to benefit from the opportunity to sell their labor services and products. It is, however, difficult to find a specific view in the structural adjustment literature about the likely structure of ownership that will emerge under a liberal policy regime. There is an explicit belief in the virtues of private business, but little attempt to spell out the inequalities of wealth and power that are likely to result. The official vision of the CCM government seems to be to accept the need for a shift to private sector development, with the accompanying pattern of income distribution, while translating the continuing verbal commitment to socialism into a concern for the provision of services to the masses (Kolimbo 1993).

The internal dynamics of policy reform can be seen as a process of state accommodation of new groups, first implicitly, by turning a blind eye to practices that were widespread, although in principle illegal, and then explicitly by adjusting the rules. From the changes begun under conditions of crisis and consolidated under structural adjustment, an African property-owning class is emerging, alongside the resurgence of minority (Asian and Arab) interests. With structural adjustment, there has been a flowering of private economic activity. Successful entrepreneurs have emerged from the minority trading communities; they had hung on through periods of state control, and became adept at pursuing rents during the period of crisis. African entrepreneurs

46 Edward Mortimer explores the possibility of viable alternatives to this Western model in terms of a possible Asian counterpart (see Mortimer 1994).
have emerged as small businessmen and from the state system.

A politically viable vision of development through the market must address the issue of national participation in the ownership of private, large-scale economic activities. Within the Tanzanian polity, one view about the future under reform has emerged from groups critical of CCM policies that restricted the scope of African businessmen in the past, and see the possibilities in the new dispensation for the emergence and consolidation of an African capitalist class. Criticism of aspects of economic liberalism are voiced by those who believe that the state should support African capitalists in competition with ethnic minorities and foreign business. The interests of segments of the African business community have been articulated through appeals for "indigenization" by such groups as the Chamber of Commerce and Agriculture and Industry, and one line of division in the new multiparty politics could emerge around that issue. There is no sharp line of division between those in politics and government and the emerging African capitalist class. Part of the process of accumulation in the development of that class involves primitive accumulation by those with access to state resources. Quite open private accumulation by leaders in the party, government, and parastatal sectors, disallowed in the self-denying "leadership code" adopted after the Arusha Declaration, has been increasingly countenanced during the 1980s.

The emergence of an African property-owning class has not yet been associated with an accentuation of ethnic tensions within African society. Given the lack of concentrated tribal makeup in Tanzania, it is less likely to be prone to the sort of ethnic divisions that have emerged in Kenya, although there have been some indications that religion could become a political factor. The new African business class, however, is emerging from among the small traders, craftsmen, and contractors, activities in which the Moslems are well represented, as well as from the bureaucratic and technocratic elite, which is predominantly Christian, and it might be that the balance between the religions will be still more equal within a growing private sector than it was within government and the parastatals.

While there is no shortage of African entrepreneurial talent in small-scale activities, one important contrast between Africa and East Asia is the lack of large-scale national capital in the former and its active presence in the latter. The prospects seem good for accelerated African small-scale development; one source of optimism is the widespread evidence of small-scale entrepreneurial initiatives in agriculture, trade, transport, construction, and craft activities. It is less clear whether a national capitalist class is emerging that is capable of working with the state to develop a program for a more advanced stage of capitalist development.

Successful visions of social change are not often handed down on tablets to great men in the mountains, but are more likely to be founded in a concrete reality of what is likely to receive support and what is likely to work. A vision of a successful economic future should be based in empirical reality, as well as incorporating acceptable ideals. There is an underlying dilemma in Tanzania, as in much of Africa, that in the absence of success, it is far from clear what that vision should be.

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47 The case for this is set out quite explicitly by Edwin Mtei, leader of Chadema and one-time executive director of the IMF, in a recent interview in the EEC Courier, November 1994.
48 Religion is mentioned here because one possible division in Tanzanian society is along religious lines. The debate over the Union has had religious undertones, and there was a brief outbreak of religious conflict in Dar es Salaam in 1993. It is difficult to predict the likelihood of future conflict. In Dar es Salaam and on the coast, there is some coincidence of religion, tribe, and economic status, with the Muslims in an underprivileged position, which could provide the basis for political discontent on religious lines. But up country the situation is more confused (for example, in Kagera and Pare)—members of the same community and even the same family may be drawn from both religions, blurring the divisions. Also, it is possible that liberalization has eased some of the economic inequalities, because Muslims are probably better represented in private commercial activities than in the bureaucracy.
Bibliography


Bolivia and the Slowdown of the Reform Process

Juan Antonio Morales

Bolivia was one of the early adjusters of the 1980s, and the success of its stabilization program of August 1985 in stopping hyperinflation has received considerable attention. The program went beyond stabilization and included a broad set of economic reforms, encompassing the liberalization of the markets for goods, money and credit, and labor. The stabilization program and these first reforms were packaged in the omnibus Supreme Decree 21060. Later, S.D. 21060 became the symbol of the new development model for Bolivia. Bolivians would refer to the liberal model in force after 1985 as the model of S.D. 21060.

In the aftermath of S.D. 21060, the government designed and implemented, in a very orderly way, an economic policy rich in transformations. Victory in the fight against inflation, a problem well-defined and clearly identified by the public, increased the mandate of the government in other policy areas.

Bolivia’s experiment of the 1980s was not only successful in controlling inflation, but was also a forerunner in the adoption of structural reforms. Equally significant, changes in government did not imply breaks in economic policy. All administrations, despite differences in personality and previous visions, have followed the development model outlined in the reforms of 1985.

After demonstrating extraordinary zeal in pursuing reform in 1985 and the first few years of the program, the momentum seems lost. I hypothesize that this happened because the new reforms demanded greater governance capacity, understood in the sense given by Frischtak (1994, p. vii), “as the ability to coordinate the aggregation of diverging interest and thus promote policy that can credibly be taken to represent the public interest.” A main objective of this chapter is to look at the missing political and institutional conditions that are needed to forcefully renew and sustain the reform process.

The most important, although still preliminary result that emerges from the study is that the Bolivian experience lends support to the hypothesis that the dynamics of stabilization and the reforms that immediately followed differ from the complementary structural adjustments. Once the situation is ripe, stabilization measures, however harsh and undemocratic, can be taken without los-

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The stabilization and the first structural reforms, which were indistinguishable during several months of the stabilization package, will be labeled, for convenience, first-generation reforms. The stabilization and the first reforms were designed to: (1) restore macroeconomic stability; (2) correct relative prices to make them closer to market-determined prices; (3) not unrelated to the point before, open the economy to foreign trade; and (4) remove the bigger obstacles to the smooth functioning of markets. These measures were mostly of a macroeconomic nature. The complementary, or second-generation, reforms are related more to a redefinition of the roles of government and the private sector, and of the national government and the local governments. Privatization and decentralization within government are central to this redefinition. Also, the complementary reforms are intended to foster institutional change to enhance savings and investment and to strengthen international competitiveness. The reform of Social Security and the laws to guarantee private investment stand out in this area.

The tax and budget reforms cross both generations of reforms, but there are distinctive differences between the two generations. The content of the first fiscal reforms was defined by the urgent need to narrow the budget deficit. This was achieved with easy-to-collect taxes and easy-to-reduce expenditures. The second fiscal reforms take a longer view. A great deal of effort is given to changes in the composition of expenditure, assuming that there is a ceiling. Also, significantly more attention is paid to the efficiency and equity issues in the tax structure, which were somewhat neglected in the first generation of reforms because of the overwhelming need for revenue.

The distinction between stabilization and the subsequent first reforms, and the second generation of reforms, can also arise (as in Naim 1994) from the way they were formulated and implemented. Naim prefers to identify the stabilization and the first generation of reforms as Phase I reforms, and our second generation of reforms as Phase II. The Phase I reforms were undertaken in the midst of a severe crisis by a small number of powerful ministers and the president of the Central Bank, advised by high-level technocrats, and isolated from political pressures. The economic theory behind the Phase I reforms is well-established, and utilizes the lessons of previous experiences in the country and elsewhere. The measures are packaged in decrees and executive orders, in Naim's words (1994, p. 8), "hard-to-decide but simple-to-execute."

The second-generation reforms are significantly more complex. Their requirements in statecraft, political adroitness, and administrative talent will be examined in detail in the pages that follow.

The market liberalizations were seen by the government of 1985 as a constituent part of, and indistinguishable from, the stabilization program. Only afterward did they acquire their own identity as structural reforms. Many doubts lingered of the permanence of the market liberalizations after the first signs of stabilization. The prevailing view in the public and in some parts of the government was that the adjustment measures were of a transitory nature. Yet there was also the conflicting perception that the hyperinflation was not only a temporary, albeit severe, disorder, but the most telling symptom of the failure of a development model, and thus that there was a need for extensive reforms with a long-term outlook. The government rapidly seized this argument. Equally important, it was a convenient contention to bring in crucial foreign aid.

Once it became clear to the public that the government was really committed to stop inflation, its capacity to formulate and implement re-
forms increased. The government could then shape a national project and offer it to the public and to the community of foreign donors. It is argued in the text that increased governance capacity was not the outcome of a previously set vision, but rather the result of the feedback between government and the public. Adjustment was essentially a dynamic process, with the contents of the program changing each time new information became available, either on the position of the public or the foreign donors.

The first-generation reforms could be delivered in clear and simple rules. The public understood the messages and accepted them. Even when the reforms introduced regulations, they didn’t stir special resistance, because they were perceived as universal. Rules, when seen as universal, are less likely to bring opposition than measures that are perceived as creating obvious and undeserving winners.

The first-generation reforms conveyed signals of fairness, and this was very important for their implementation. Even if they entailed costs, the so-called “social costs,” they were lower than the costs of macroeconomic disarray. Similarly, the market liberalization appeared to place in the open widespread, but hidden, practices. More transparency was seen as an increase in fairness. Everybody could benefit from what had previously been benefits only for the few with privileged information. When regulations were imposed on some sectors—for example, banking—they did not tamper with prices or dictate the allocation of productive activities. Instead, they took the form of rules of prudence, which were understood as preserving the common good of the sector, even by those directly affected.

This chapter is organized as follows. The first section surveys the conditions preceding S.D. 21060 and the contents of the stabilization package of 1985. The next section offers a description of the state of the reforms, and ends with some quantitative results. In the third section, I look at the political competence of the reformist governments in dealing with the adjustment measures and coping with the opposition. The fourth section considers governance capacity, with an emphasis on the fiscal accounts and the difficulties met in two of the second-generation reforms, privatization and Social Security reform. The final section offers some concluding remarks.

**S.D. 21060 and Its Background**

It has become customary in the current Bolivian political science literature to place the beginning of the state-led development model in the Revolution of 1952, and its end in the structural changes brought by the set of measures encompassed in Supreme Decree 21060 of August 29, 1985. This section sketches the main political and economic developments between these two landmarks and provides a thorough description of the reforms included in S.D. 21060.

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1 To the informed, they looked like simplistic rules of thumb, such as “governments should not spend more than they receive.”

2 There is a public good argument to justify the acceptance of the prudential rules. Everybody in the sector could find the prudential rules desirable, but only if everybody else was accepting them. The coordinating role was left to the government.

3 See, for example, Sachs and Morales 1988 and the references therein.
high share of public investment in GDP and in total investment—not only in infrastructure but also in the agroindustrial and manufacturing sectors—became a permanent and prominent feature of the model.

Of equal importance with public investment was the establishment of a complicated system of incentives and sanctions to influence private sector production and investment decisions. The main intervention instruments were the allocation of heavily subsidized credit and tax incentives. There were also protective barriers to shelter domestic industry from competitive imports, although they were not as important as in the other Latin American countries, mainly because Bolivia's geographic position provides natural walls to trade.

The overexpansion of state involvement in the economy was a source of job patronage, as well as clientelism in contracts of public works and purchases of the government and the state-owned enterprises (SOEs). In the past forty years, Bolivia has had the highest share of public employment in the total urban labor force in Latin America, except for Cuba. In addition, after 1952 a segment of the middle classes emerged whose wealth and income resulted from the predation of public resources. Corruption became common, and its scope augmented compared with previous years.

The MNR stayed in power during twelve eventful years. It was overthrown by the military in 1964. The internal strife in the MNR and its worn-out power were as much behind the coup as the ambitions of the military. Despite the demise of the MNR, the state capitalism model was continued by all governments between 1952 and 1985, military and civilian alike, independent of their political orientation.

General Hugo Banzer's government stands out among the military governments, not only because it lasted seven years (1971–78), but also because it gave a strong impetus to the modernization of the economy. The heyday of the state capitalism model was reached during his reign. This seems paradoxical in view of his conservative and strongly anticommunist stance. Ironically, the possibility of obtaining loans in private capital markets in that period gave a further impetus to state involvement in the economy.

Despite his notorious disrespect for human rights, Banzer and the other long-lived authoritarian governments enjoyed the support of ample segments of the population, particularly in the middle and upper classes, with their calls for order. These authoritarian governments had some legitimacy and clearly exerted power over society.

For short periods (1970–71 and 1978–82), all indications of governance capacity were lost. During a populist military government in 1970–71, lack of social discipline manifested itself in illegal occupations of private property, wildcat strikes, and many attempts at coups d'état. The second period, 1978–82, was characterized by interim civilian presidents and a succession of military governments. The nadir of this critical period was in 1980, when a military junta, with close ties to the cocaine traffic, took power.

Democracy returned to Bolivia in the last quarter of 1982, after eighteen years, with only short interruptions by authoritarian governments. The first democratic government (1982–85), headed by Mr. Hernán Siles-Zuazo, was backed by a coalition of leftist parties, including the Communist Party of Bolivia. The labor unions initially favored Siles-Zuazo, but later in his term withdrew their support and were among his more violent opponents.

Siles-Zuazo inherited a very difficult economic situation, prompted largely by the foreign debt crisis. Unable to address the economic predicament and all the pressures that went with it, he had to resign the presidency one year before the end of his constitutional mandate. It was during his term in office that hyperinflation erupted. By mid-1985, Bolivia's economy was in complete disarray, and the accompanying social and political unrest threatened democracy.
President Siles-Zaazo had to call anticipated elections, which took place in July 1985. After the elections, Congress chose Mr. Víctor Paz-Estenssoro as president. He came with the support of his aging populist party, MNR. As mentioned above, the MNR was the party of the Revolution of 1952, when the state capitalism model started. In a turnaround, Paz-Estenssoro and the MNR decided on a radical transformation of the development model, putting in place very ambitious structural reforms.

The MNR signed a pact, the Pact for Democracy, with the Democratic Nationalist Alliance (henceforth, ADN, the Spanish acronym), a rightist party led by General Banzer, to carry on the liberal revolution. Since this initial signing, pacts have become a permanent feature of Bolivian politics.

Paz-Estenssoro was succeeded in 1989 by Mr. Jaime Paz-Zamora. He also formed a coalition government between his formerly leftist party, the Revolutionary Leftist Movement (MIR, the Spanish acronym), and ADN. Paz-Zamora pursued the policies set by his predecessor. The change in MIR’s stance was as surprising as the change of course of the MNR.

The current president of Bolivia, Mr. Gonzalo Sánchez de Lozada, began his presidency in August 1993. He governs with his party, the MNR, and three smaller parties; in this group, the Free Bolivia Movement (MBL), a dissident segment of intellectuals of MIR, stands out. Sánchez de Lozada was the Minister of Planning (actually, the Minister of the Economy) during the government of Paz-Estenssoro and the main architect of the changes.

Hyperinflation
Bolivia suffered a dramatic episode of hyperinflation between 1982 and 1985. There is a professional consensus that the hyperinflation was prompted by the accumulation of large fiscal deficits between 1975 and 1981, financed with foreign loans. The general situation of the Latin American debt, and the particular exposure of Bolivia, triggered an external crisis in 1982 that almost immediately led to hyperinflation. Numerous disruptive factors converged. First, accumulated trade surpluses were needed to service the foreign debt. The available instrument was the depreciation of the currency, which not unexpectedly was strongly resisted by the workers. On the path to a higher real exchange rate, strong inflationary pressures emerged. Second, and more important, the financing of the fiscal deficit with foreign loans was replaced with credits of the Central Bank, which required excessive issuance of money. Since the government could no longer roll over its debt to the foreign creditors, and there was no domestic market for government paper, the Central Bank loans became almost the only source of financing of the fiscal deficit.

As the public finance models of inflation predict, this mode of deficit financing interacted with the public’s demand for money, and resulted in high rates of price growth. In addition, inflation itself further aggravated the fiscal deficit through Olivera-Tanzi effects.

Bolivia found itself very rapidly in a high and accelerating inflation path. Government attempts at control by fixing prices and the exchange rate were futile; worse, they became counterproductive. Black markets soon appeared. The premium on the black market for foreign exchange over the official rate was especially notorious: at times, it went up to 1,300 percent. Together with supply shortages, this led to frequent incidents of severe social unrest.

Contrary to the diagnosis of inflation in neighboring Argentina, Brazil, and Peru, for most of

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4 The domestic market for government bonds disappeared in the early 1930s, in the aftermath of the Great Depression. In 1987, the Central Bank started offering certificates of deposit to domestic savers. Open market operations with Treasury bills started in 1994.
this period the government, its economists, and the public were convinced that the pillar of stabilization was fiscal correction. Between 1982 and mid-1985, there were at least six attempts to stabilize. Except for the first attempt, all were "orthodox" in the sense that fiscal and monetary restraints were the main intermediate targets (the ultimate target, of course, was the control of inflation). They all failed. Their failure was not attributed to an incorrect conception, but to having been halfhearted measures, with a gradualist approach to a condition that required a shock treatment.

By 1982 the illegal trade in cocaine had become a major disruptive factor to politics and economic management. The failures of the Bolivian government to take action against the drug traffic, as evaluated by the United States government, directly interfered with the design of economic policy between 1982 and 1985. For instance, independently of the technical merits of the successive stabilization plans, crucial financial support from the United States was withheld. Cocaine continues to play a major role, even after the reforms of 1985, both in Bolivian politics and in economic policymaking.

Stabilization and Reform with S.D. 21060

Three weeks after his inauguration, President Paz-Estenssoro announced a stabilization plan in S.D. 21060. The plan was prepared, in great secrecy, by no more than seven persons. Also, the process of carrying out the program was the responsibility of only a few people.

Exchange rate unification was central in the program. This measure was supported by very tight fiscal and monetary policies. The fiscal measures were especially strong. On the revenue side, the price of fuels was hiked by a factor of seven. This increased the tax collections on fuel consumption by the same factor. In addition, the state-owned petroleum enterprise, YPFB, was obliged to deposit all of its sales proceeds daily in an account in the Central Bank. Subsequent use of the deposit was then tightly controlled by the government. The deposits worked as a powerful brake to the expansion of money; later, a significant portion of the deposits was transferred to the Treasury. To this day, taxes on fuels, particularly transfers from YPFB, are among the most important sources of Treasury revenue.

On the expenditure side, the measures were also drastic. Approximately 10 percent of the labor force in the public sector lost their jobs. The policy of dismissals was extremely crude, with no consideration of age or reemployment possibilities. Wages and public sector investment were frozen for an initial period of six months. To give a clear message to the public of the government's commitment to fiscal correction, the budget was managed on a cash-flow basis in the first years of the stabilization program.

To mitigate the costs of the adjustment, the government created the Emergency Social Fund (ESF) in 1987. ESF has received considerable attention and praise for its accomplishments in the international financial institutions (IFIs). It was very efficiently run, and for a while it became an example for other countries to follow. Yet, like all narrowly targeted policies, ESF suffered from political isolation. The very poor are not the main losers in adjustment; it is the politically vocal lower-middle-classes and unionized workers that suffer the higher drops in both take-home income and government transfers in an adjustment process. There was no mitigation program for them, except through larger than usual severance payment.

The markets for goods and factors, except land, were greatly liberalized. Price controls were lifted, import tariffs were lowered, and most quantitative restrictions on imports and exports were eliminated.

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5 The inability to formulate a heterodox stabilization plan reflected, to a large extent, the lack of domestic analytic talent. Orthodoxy had the advantage of being a well-known recipe.
Liberalization seemed at odds with the prevailing thought on stabilization. On purely technical grounds, the onus of stabilization had to fall on fiscal and monetary restraint; liberalization was not necessary, and could even be counterproductive. The foreign trade liberalization could—and did—deteriorate the trade balance. The deregulation pushed steeply upward, in an once-and-for-all movement, the prices of wage goods, which fueled labor requests for higher wages. Had it not been for the extraordinary resistance of the government to pressures to raise wages, the program would have capsized.

The program checked inflation very rapidly, unified the exchange rates to the market-determined rate, and substantially reduced the fiscal deficit, at least in the first years. On purely technical grounds, a less drastic plan would probably have achieved the same results. The overkill essentially had an announcement value. The government needed to differentiate its program from the previous ones that, although similar in content, had failed. The package of stabilization cum liberalization, a bit by accident, integrated correct economic policy ingredients and the right political announcement features to convince the public of the government’s commitment to stop inflation.

An unorthodox but crucial step was included in the program—the suspension of payments on the foreign debt to commercial banks until a definite arrangement could be reached with them. Loan service to official lenders continued.

The IMF accepted the stabilization plan, although it had some disagreements on the management of the exchange rate and the suspension of the commercial debt service. The World Bank offered its support to the program from the very beginning. More generally, the external agencies have played a very important role in the stabilization and subsequent reforms. Bolivia has enjoyed (sometimes endured) their technical and financial support since the first measures in 1985.

State of the Structural Reforms

Tax Reform

Once the high inflation seemed to be receding, the reconstruction of taxation appeared to be the next step necessary to consolidate the program. Remember that a main victim of the hyperinflation had been the tax system. Besides the inherent deficiencies in the previous tax structure, Olivera-Tanzi effects had destroyed the tax administration. A new tax law was passed in June 1986 to enhance the stabilization package.

The tax reform of 1986 featured only eight taxes, if the special treatment to small taxpayers is excluded. The most important tax, by far, is the value added tax (VAT), which currently has a uniform rate of 13 percent (it started at 10 percent). Wages and income from assets receive a similar treatment to that of any sale subjected to VAT. (Note that there was no tax on profits, but on presumed income.) They bear a complementary VAT, from which VAT payments made on expenditures can be credited. This tax carries the same rate as the VAT on personal saving. It can be observed in tables 6 and 7 that the real value of VAT collections and its share in the current revenue of the National Treasury have been steadily increasing.

Following the launching of tax reform, a great effort was devoted to enforcement and administration. The registers for taxpayers were updated, a mechanism for cross-checks of VAT was created, and the system was fully computerized. Many, particularly small, businesses were closed.

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6 The tax law of 1986 was fully reformed in December 1994. Between 1986 and 1994, it had suffered some minor changes.
7 Bolivia now has one of the most modern tax registers in the region.
by the authorities for fiscal fraud. The contribution of tax reform to the fiscal position was undoubtedly significant, yet the most important taxes to that end were the “taxes” on fuels, which were included in S.D. 21060.

Was the tax reform of 1986 necessary on intrinsic technical grounds? The subject is debatable, because once inflation had abated, a reversed Olivera-Tanzi effect would have increased revenues. Also, the previous tax system was not without merits. It is true that a myriad of taxes (400?) existed before 1986, but the ones that raised revenue in significant amounts were no more than ten. The remaining 390 were a nuisance, but they did not really impair tax administration, nor were they a source of corruption. The most important criticism that can be made of the tax structure before 1986 is that the weight of taxes on foreign trade (tariffs, and on exports of the mining and oil sectors) was too high.

It is also true that tax compliance was very low during hyperinflation, but this was not necessarily caused by an increase in corruption in tax administration. This effect was, again, a by-product of inflation and demoralization in the internal revenue services and in the public enterprises selling services. The employees felt that to enforce the tax laws was not worth the trouble, given that what they collected from taxpayers and for service fees was so little in real terms.

Tax reform was needed essentially because of its announcement value. The government had to send the message that rebuilding tax collections had a top priority in its agenda of fiscal correction, the latter being the most important component of the stabilization package.

Trade Reform

Both economic and political causes explain Bolivia’s success in trade liberalization. Among the former, the low degree of industrialization stands out. Among the latter, one can identify the correct assessment of the forces of the potential opposition, as well as tenacity in government.

The steps taken to liberalize trade were forceful. S.D. 21060 eliminated almost all quantitative restrictions and lowered tariffs. Later, further reforms led to a tariff structure consisting of flat ad valorem tariffs, with a rate of 10 percent, except for a small list of capital goods, whose rate is 5 percent.

Trade liberalization was very quick and, as with many of the first reforms, met little hostility. The opposition came from businesses in the manufacturing sector and from large agriculturalists. The National Chamber of Manufacturers hired a consulting company to compute effective rates of protection, and based on this technical report pressed for changes in the tariff structure. Similarly, the powerful Eastern Chamber of Agriculture (henceforth, CAO, the Spanish acronym) lobbied for changes. The government adamantly refused.

It must be said that the pressures were not very strong, given that there were conflicting views among the diverse sectors. On the one hand, almost everybody wanted the “model” to succeed, avoiding a return to the ominous years of 1982–85. On the other hand, while they perceived liberalization as costly, they were uncertain of the scope of the prereform protection, and even more unsure of the proposals from their umbrella organizations. In addition, many sectors were accustomed to competing with contraband imports, and what they resented was not so much the lowering of tariffs on their final products, as the increase in tariffs for their inputs. They felt that the fall in effective rates of protection was caused by the uniformed tariffs rather than the lower tariffs for competitive imports.

Contrary to the expectations of many Bolivian economists, output in the manufacturing sector strongly and positively reacted to the stabilization program.8 The beneficial effects of the

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8 Unfortunately the growth of the manufacturing sector was not reflected in the overall GDP rate of growth because of the small initial contribution of the sector.
reduction in uncertainty more than compensated the dismantling of trade barriers. The government correctly anticipated this reaction. Still, results varied across subsectors. In some branches there were many closings. The manufacturing sector, because of its smallness, traditionally had little voice in influencing policies. Enterprises in many sectors opted for exit, given that their voice was unlikely to be heard.

CAO’s lobbying was more effective. Their associates suffered from higher tariffs on imported inputs and from agricultural imports whose competitive edge was provided by the very rapid exchange rate depreciations in neighboring Peru, Argentina, and Brazil. The government did not yield to the demands of the CAO, but it went to significant lengths to compensate CAO’s associates. Since many of them were exporters, a subsidy of 10 percent of the free on board (FOB) value of exports was granted, allegedly a drawback for taxes on imported inputs. Moreover, transportation fees in the state-owned railroads were reduced, to CAO’s benefit. In 1991 the export subsidy was lowered to 2 percent for agricultural exports, a rate that is closer to a true drawback than the previous higher rate.

The most significant concession, however, was the reestablishment of lines of credit, among them an important International Development Association (IDA) loan, labeled “Eastern Lowlands Project.” The IFIs went full force to help in the development of agricultural exports, particularly of soybeans. This program partially silenced CAO’s demands.

Financial Sector Reform

Another area where considerable statecraft was exerted was in the reform of the financial, mainly banking, sector. The banking sector had known a considerable rate of growth between 1964 and 1982. Their lending operations were made increasingly from sources other than their deposits, either long-term loans refinanced at the Central Bank or borrowing abroad, especially in the second half of the 1970s.

The long-term loans (called “development loans”), discounted at the Central Bank at highly subsidized interest rates, caused great inefficiency in the allocation of scarce credits and were also a source of quasi-fiscal deficits. Still worse, the borrowers of these loans were notoriously delinquent. The state-owned development banks exhibited the worst delinquency rates. The beneficiaries, especially in the agricultural areas of east Bolivia, came to believe that the loans were grants, and did not need to be repaid. Access to highly subsidized credit was one main manifestation of clientelism in the old regime. It was actually a perverse instrument of wealth distribution to favor the privileged groups that captured the state.

The macroeconomic instability of 1982–85 brought significant distress to the balance sheets of the banks. After the stabilization, banks rapidly recovered deposits, almost all denominated in dollars, by offering very high interest rates. They increased their lending rates pari passu with those for borrowing. The high rates rapidly deteriorated their loan portfolio, however, and by mid-1987, two years after the stabilization program, Bolivia faced a banking crisis in which four banks had to close.

Thus, a clear case for prudential regulation and more supervision appeared. Several steps were taken in that direction. First, the minimum reserve requirement for dollar time deposits was raised to 10 percent (it had been 0). Second, banks had to abide by a rule of a minimum ratio of equity capi-

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9 CAO continues to be a powerful lobby. Its efforts in the recent past have been addressed to measures of debt alleviation for their highly indebted associates.

10 The Central Bank was, in addition to its monetary role, a second-tier bank. It lent to the commercial banks from funds obtained abroad, normally from the IFIs or foreign government agencies, and by printing money.

11 The loans to the cotton growers in the eastern region of Santa Cruz in the late 1970s epitomized this situation.
tal to loans, in line with the Basle accords. Third, the supervision of banks was severed from the Central Bank and established in an independent Superintendency of Banks, accountable to the legislative branch. Later, as a component in the package of financial reform, the state-owned banks were closed.

The domestic banks are now more regulated and supervised than ever in their history. The Superintendency of Banks rapidly established its power, which helped to attenuate the banking crisis of 1987–88. Many of the financial sector reforms, in spirit if not in letter, have been incorporated in the Banking Law of 1993. This law resulted from long negotiations in Congress; the lobbying of the Association of Bolivian Banks had significant influence, but it did not change the main tenets of the policies set between 1987 and 1992.

Development credits are now intermediated by private financial institutions. The Central Bank auctions the credits among them. While there are some technical criticisms of the auction process, the principle that all allocation of resources should be market-based is indeed correct. The auctions, as a market mechanism, also provide a signal of fairness that contrasts with the administrative allocations used in the past.

Incentive Regimes and New Investment Codes

Around 1990 the government authorities started to think that the liberalization of goods and factor markets was a necessary step to promote investment, but it was not sufficient. A new investment code and sectoral codes for the investments in mining and oil were enacted by Congress in 1990 and 1991.

The new investment code adds few elements to the prevailing economic policy. It reiterates the guarantees for investment that are in the Constitution and the Civil and Commercial Codes. It tries to cement in legislation the reforms that had been ruled in administrative acts of the executive, such as Supreme Decrees, that legally are transitory in nature. It has to be seen as a precommitment device to reduce the likelihood of policy reversals. Although it is true that laws can be changed, in the current institutional context it takes a two-thirds majority to repeal a law; the reforms undertaken since 1985 have thus been given more permanent support through the investment code. It is important to underscore that the code does not offer tax concessions, as used to be the case in previous codes.

The laws on mining and hydrocarbons are important to the attraction of foreign investment. The treatment of the property rights of the concessions was clarified, and a profits tax, set at a very low rate, was introduced to replace the previous system of output taxes. The new mining law also allows the formation of joint ventures between the state-owned mining corporation COMIBOL and private enterprises. In hydrocarbons, the possibility was opened to extend the system of production sharing between the state-owned oil company and foreign firms that had been in place for many years to include joint ventures—that is, to schemes of risk sharing. With these reforms, Bolivian legislation in nonrenewable natural resources is among the most liberal in Latin America.

The formation of joint ventures with COMIBOL has been far from smooth because of the opposition of the miners. They have been able to block almost all attempts. Although COMIBOL has been in disarray for many years, the government could not convince the union of miners to acquiesce to the joint ventures. The promise of very high severance payments has produced little result to date. The mishandling of the labor problem in the state-owned mines appears as a clear governance failure.

Pending Reforms

Bolivia still has to undertake some important and difficult structural reforms, including the areas of
Bolivia and the Slowdown of the Reform Process

privatization; the Social Security system; increasing the flexibility of the labor market; decentralization of public education and health; liberalization of the legislation on land tenure; and the independence of the Central Bank. For the sake of brevity I will concentrate on the two most controversial reforms: privatization and Social Security reforms.

In 1991 the executive obtained passage of a law of privatization for small SOEs from Congress, but no more than twenty-five of over one hundred have been privatized to date. Even if the small SOEs were insignificant in employment and investment, their privatization has met strong opposition.

The urgency of the reforms of the Social Security system cannot be underestimated. The system as it stands, with its twin features of a pension fund and medical insurance, could not be in a sorrier state. Pensions are dismally small and are paid late. Similarly, the medical services are of a very poor quality. Yet opposition to change is so strong that the authorities do not feel confident enough to send the draft laws to Congress.

The government of Sánchez de Lozada, more forcefully than its predecessor, is trying to give a new momentum to the reforms. It has two innovative proposals: capitalization and popular participation. The idea behind capitalization, in brief, is to convert the state enterprises into joint-stock companies, then increase their capital by issuing new shares and selling them to the private sector. The new shareholders will control the companies, regardless of the shares they own. Once the companies are capitalized, the government shares will be distributed, free of charge, to all adult Bolivians, in a pattern similar to that followed in some countries of Eastern Europe. The distribution of shares, however, will not be direct. They will go to the pension funds, in which all Bolivians are supposed to be enrolled. Capitalization is actually a convoluted process to circumvent opposition to privatization of the large SOEs.

Popular participation is an ambitious plan to decentralize the national government's social services to the local governments and to enhance participatory democracy. At first, funds will be channeled to the municipalities, which will be given the task of providing health, education, and other services of lesser importance. It is expected that municipalities will be able to raise a portion of the necessary taxes to provide for those services locally at a later time.

The capitalization and popular participation proposals have been approved in Congress and have become law. The implementation of the laws, however, is lagging.

Overall Measures of Adjustment Success

It can be observed in table 1 that the achievement in controlling inflation (measured by percentage changes in the Consumer Price Index) is truly remarkable. The inflation rate for 1993 was 9.5 percent, and for 1994, 8 percent. Similarly, the evolution of the real exchange rate has been favorable. This result was brought about by the combination of a correct domestic policy and external developments, such as the high exchange rate appreciations in important trade partners. Bolivia is now a reasonably open economy, as shown by the (exports + imports) ratio to GDP, despite a poor export performance.

The other indicators of economic performance have been modest. Bolivia has been running very high trade deficits for several years, and their effects on the domestic economy have been attenuated only by substantial amounts of foreign aid. The contribution of gross foreign savings to the formation of capital is very substantial, possibly higher than in any other country at the same stage of development. The high BOP current account deficits are partially explained by debt service. Despite the substantial relief negotiated from the largest creditors, foreign debt continues to be very high in relation to the size of the economy.
Table 1
Bolivia’s Key Indicators after Reform
Percent

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<tbody>
<tr>
<td>Real GDP growth</td>
<td>-2.5</td>
<td>2.6</td>
<td>3.0</td>
<td>2.7</td>
<td>2.7</td>
<td>4.1</td>
<td>2.0</td>
</tr>
<tr>
<td>Real per capita GDP growth</td>
<td>-4.5</td>
<td>0.5</td>
<td>0.8</td>
<td>0.6</td>
<td>0.6</td>
<td>2.0</td>
<td>-0.1</td>
</tr>
<tr>
<td>Consumer price changes (Dec. to Dec.)</td>
<td>66.0</td>
<td>10.7</td>
<td>21.5</td>
<td>16.6</td>
<td>18.0</td>
<td>14.5</td>
<td>10.5</td>
</tr>
<tr>
<td>Terms of trade index (1980 = 100)</td>
<td>85.5</td>
<td>69.6</td>
<td>61.1</td>
<td>67.8</td>
<td>59.2</td>
<td>49.8</td>
<td>43.4</td>
</tr>
<tr>
<td>M1 growth (Dec. to Dec.)b</td>
<td>82.9</td>
<td>39.3</td>
<td>30.9</td>
<td>-2.4</td>
<td>28.3</td>
<td>25.2</td>
<td>19.0</td>
</tr>
<tr>
<td>Interest rate on dollarized time deposits</td>
<td>15.0</td>
<td>15.6</td>
<td>15.0</td>
<td>15.1</td>
<td>13.4</td>
<td>10.1</td>
<td>11.2</td>
</tr>
<tr>
<td>Real exchange rate (December 1987 = 100)b</td>
<td>n.a.</td>
<td>100.0</td>
<td>85.7</td>
<td>85.1</td>
<td>127.5</td>
<td>127.6</td>
<td>125.2</td>
</tr>
<tr>
<td>Service on public and publicly guaranteed debt as percent of exports of goods and services</td>
<td>29.6</td>
<td>24.7</td>
<td>41.9</td>
<td>27.7</td>
<td>32.8</td>
<td>27.3</td>
<td>n.a.</td>
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Percent of GDP

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<tr>
<td>Private fixed investment</td>
<td>4.7</td>
<td>4.0</td>
<td>4.2</td>
<td>4.1</td>
<td>4.3</td>
<td>4.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Consolidated NF-public sector deficit</td>
<td>2.8</td>
<td>7.7</td>
<td>6.5</td>
<td>5.1</td>
<td>3.3</td>
<td>3.6</td>
<td>4.7</td>
</tr>
<tr>
<td>Exports + imports</td>
<td>32.3</td>
<td>29.8</td>
<td>29.2</td>
<td>35.2</td>
<td>39.9</td>
<td>34.6</td>
<td>33.8</td>
</tr>
<tr>
<td>BOP current account deficit</td>
<td>10.3</td>
<td>11.8</td>
<td>11.1</td>
<td>8.5</td>
<td>8.3</td>
<td>9.5</td>
<td>14.3</td>
</tr>
<tr>
<td>Total external debt</td>
<td>107.6</td>
<td>113.1</td>
<td>100.8</td>
<td>84.7</td>
<td>92.1</td>
<td>81.2</td>
<td>81.7</td>
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<tr>
<td>Net transfers on debt</td>
<td>3.3</td>
<td>2.2</td>
<td>1.0</td>
<td>3.0</td>
<td>-0.6</td>
<td>0.6</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total official development aid</td>
<td>8.3</td>
<td>7.4</td>
<td>8.9</td>
<td>12.1</td>
<td>13.3</td>
<td>12.1</td>
<td>11.8</td>
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Memo

GDP at current prices (US$ million)

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<tr>
<td>3,903</td>
<td>4,306</td>
<td>4,422</td>
<td>4,509</td>
<td>4,499</td>
<td>5,014</td>
<td>5,263</td>
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Exports of goods and services (US$ million)

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<tr>
<td>685</td>
<td>667</td>
<td>690</td>
<td>891</td>
<td>998</td>
<td>942</td>
<td>798</td>
<td></td>
</tr>
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</table>

n.a. Not available.
a. Growth of M1 in domestic currency.
b. Increase in index indicates increase in competitiveness.
c. Preliminary.

Only since 1991 has the per capita real GDP growth reached the range of 0–2 percent. More troublesome than the low GDP growth rates are the very low rates of investment of the private sector, which are even lower than in some of the hyperinflation years. Several factors explain the low investment rates.

First, with a more open economy and fundamental changes in the international context and in our close neighbors, the effects of the lack of infrastructure and of skilled labor are felt more strongly than in the past, when the economy was more closed. In other words, the deficiencies in basic infrastructure and skills showed more sharply once the economy opened.

Second, Bolivia’s traditional exports have faced very low prices since 1985, well below historical levels. The fall in the export prices of minerals, especially tin, and of natural gas has caused a huge drop in the terms of trade; the index in 1992 was only 43.4 percent of the 1980 index. The resulting loss of income has affected

12 Preliminary estimates for 1994 show a per capita real GDP growth of over 2 percent.
the saving rate, and therefore the investment rate. The substantial flow of foreign aid has not been able to compensate for this. Also, the low export prices have affected the decisions of foreign investors.

Third, the high real interest rates from 1986 to 1993, partially caused by the stabilization effort, inhibited the investment of the small and medium-size enterprises that can only borrow in the domestic market. Also, the high interest rates pulled entrepreneurial talent from production activities toward financial speculation or commerce with a rapid turnover of inventories.

Fourth, the taxation of enterprises in the tax law of 1986 was clearly deficient. A presumed income tax was imposed on business, with their net worth as reported in their books as the tax base. The tax penalized capital-intensive industries, while enterprises intensive in intangible assets, such as the services sector, went almost untaxed. In addition, enterprises had to pay the tax regardless of the rate of utilization of installed capacity and current profits.

Last, there is an enduring perception that some of the reforms may be reversed, which would punish investments already undertaken and irreversible. The incomplete credibility of the reforms is based on two factors. The slow growth and low investment feeds back on the investment decisions through an expectation channel. The recurrent social unrest, caused by the high underemployment rates and the low wages, awakens fears of political instability. Investment is usually a cumulative process, where sufficient previous investment is needed to bring more investment. Otherwise, new investors fear that taxation would fall out of proportion on the capital expenses of the few that have invested. This creates a coordinating role for the government; its absence can be thought of as a shortage of governance capacity.

The qualitative effects of the reforms, however, are probably more favorable than the numbers indicate. There is no doubt that economic policy is now significantly more orderly than before. In addition, the country has developed more resilience to external shocks. One proof of this is the robustness of the anti-inflation program in the face of the severe external shocks caused by the extraordinary fall in the terms of trade, as previously mentioned.

**Measures of Success in Fiscal Adjustment**

**General Measures of Fiscal Stance**

The best picture of the Bolivian fiscal stance is given by the accounts of the consolidated nonfinancial public sector (NFPS). The structure of the NFPS, as well as its relation with the financial public sector, is shown in figure 1. The budget of the consolidated NFPS merges the accounts of the general government and the SOEs.

Table 2 shows that, except in 1986, in the immediate aftermath of the stabilization program, the overall fiscal deficits (deficits of the consolidated nonfinancial public sector) have continued to be high, certainly higher than expected for a country that has stabilized inflation. In 1990 and 1991 the deficits came down to more acceptable levels, but again in 1992, and especially in 1993 (not shown in the table), there was a significant slippage, with the deficit reaching 5.8 percent of GDP. The deficits in the past two years were not as much caused by a decline in tax effort as by an expansion of expenditures, mainly for investment.

A partial explanation of the high overall deficits is given by the interest payments that continue to weigh heavily in the fiscal accounts. If the fiscal effort is measured by the primary balance, the results between 1986 and 1991 are not that worrisome. Since 1986 there have been some modest surpluses or small deficits (1987 provides an exception). It must also be mentioned that since 1986 there generally have been surpluses in the current account balance, although they were not large enough to finance the public sector's investment program. A structural (and undesirable) feature is that most capital expenditure is externally financed.
Table 2 also illustrates significant structural changes regarding the size of the public sector in the economy. The fall in total expenditure, as a percentage of GDP, from the high levels at the start of last decade is very significant. The fall has been caused by a reduction in the purchases of goods and services of the SOEs. The wage bill, after a significant reduction in 1986–87, has returned to prereform levels.

If the deficits have not been inflationary, it is because they have been financed mainly with external resources. This method of financing, which leads to the accumulation of foreign debt, may have future, unwanted consequences.

The Structure of Public Spending

Table 2 offers a first breakdown of the expenditures of NFPS; unfortunately, there are no more detailed breakdowns. These exist only for the accounts of the central government. As can be seen in table 3, the financing of the National Treasury to social sectors shows a declining share between 1987 and 1992, contrary to public statements. Among the social sectors, only urban affairs has increased its participation somewhat in the total expenditure of the central government. In an unwelcome development, there is rising share of expenditure for non-social services in the total financing by the Treasury.

Table 4 completes the picture of the spending of the central government. There is an increasing share of foreign contribution to the budget of the social sectors, especially to the budget of the health sector. Also, as mentioned above, most public investment is financed by foreign sources. The comparison of tables 3 and 4 thus suggests that the financing of the social sectors by the National Treasury is being replaced by foreign aid, another unwelcome development.

Table 5 provides a rough idea of the current transfers to the private sector by the central government. These transfers have never surpassed 2

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13 Also, public health services are increasingly financed by user’s fees.
Table 2  
Operations of Nonfinancial Public Sector  
Percent of GDP  

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<tbody>
<tr>
<td>Current revenue</td>
<td>35.8</td>
<td>26.3</td>
<td>29.2</td>
<td>25.3</td>
<td>26.5</td>
<td>27.5</td>
<td>29.4</td>
<td>29.6</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>9.0</td>
<td>3.4</td>
<td>6.2</td>
<td>8.2</td>
<td>8.2</td>
<td>7.4</td>
<td>8.0</td>
<td>7.4</td>
</tr>
<tr>
<td>Sales of the SOEs</td>
<td>25.1</td>
<td>21.2</td>
<td>22.0</td>
<td>15.9</td>
<td>17.0</td>
<td>17.9</td>
<td>18.7</td>
<td>19.8</td>
</tr>
<tr>
<td>Domestic sales</td>
<td>12.0</td>
<td>7.5</td>
<td>12.1</td>
<td>9.6</td>
<td>10.3</td>
<td>10.6</td>
<td>11.2</td>
<td>13.7</td>
</tr>
<tr>
<td>Exports</td>
<td>13.1</td>
<td>13.8</td>
<td>9.9</td>
<td>6.3</td>
<td>6.7</td>
<td>7.3</td>
<td>7.6</td>
<td>6.2</td>
</tr>
<tr>
<td>Other revenue</td>
<td>1.7</td>
<td>1.7</td>
<td>1.0</td>
<td>1.2</td>
<td>1.2</td>
<td>2.2</td>
<td>2.7</td>
<td>2.4</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>36.6</td>
<td>32.1</td>
<td>27.7</td>
<td>27.1</td>
<td>25.2</td>
<td>25.4</td>
<td>26.5</td>
<td>25.7</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>11.5</td>
<td>10.6</td>
<td>7.3</td>
<td>8.1</td>
<td>9.7</td>
<td>10.5</td>
<td>11.0</td>
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<tr>
<td>Goods and services</td>
<td>15.7</td>
<td>12.6</td>
<td>9.9</td>
<td>8.4</td>
<td>7.5</td>
<td>7.7</td>
<td>7.6</td>
<td>7.5</td>
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<td>Interest</td>
<td>3.5</td>
<td>4.9</td>
<td>6.1</td>
<td>4.4</td>
<td>4.2</td>
<td>3.8</td>
<td>3.3</td>
<td>3.3</td>
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<td>Transfers to private sector</td>
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<td>1.8</td>
<td>2.1</td>
<td>2.1</td>
<td>1.1</td>
<td>2.1</td>
<td>3.5</td>
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<tr>
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<td>2.1</td>
<td>2.5</td>
<td>4.1</td>
<td>2.7</td>
<td>1.3</td>
<td>1.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Current account balance</td>
<td>-0.8</td>
<td>-5.8</td>
<td>1.5</td>
<td>-1.8</td>
<td>1.2</td>
<td>2.2</td>
<td>2.9</td>
<td>3.9</td>
</tr>
<tr>
<td>Capital revenue</td>
<td>0.5</td>
<td>0.2</td>
<td>1.2</td>
<td>0.2</td>
<td>0.9</td>
<td>0.7</td>
<td>1.3</td>
<td>1.7</td>
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<td>Capital expenditure</td>
<td>6.5</td>
<td>4.9</td>
<td>5.5</td>
<td>6.1</td>
<td>8.1</td>
<td>8.0</td>
<td>7.5</td>
<td>9.2</td>
</tr>
<tr>
<td>Capital account balance</td>
<td>-6.0</td>
<td>-4.7</td>
<td>-4.3</td>
<td>-5.9</td>
<td>-7.2</td>
<td>-7.2</td>
<td>-6.1</td>
<td>-7.5</td>
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<tr>
<td>Other expenditure</td>
<td>0.6</td>
<td>6.6</td>
<td>0.0</td>
<td>0.0</td>
<td>0.5</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total revenue</td>
<td>36.3</td>
<td>26.5</td>
<td>30.4</td>
<td>25.5</td>
<td>27.3</td>
<td>28.3</td>
<td>30.7</td>
<td>31.4</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>43.6</td>
<td>43.6</td>
<td>33.2</td>
<td>33.3</td>
<td>33.8</td>
<td>33.3</td>
<td>34.0</td>
<td>35.0</td>
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<tr>
<td>Primary surplus/deficit</td>
<td>-3.9</td>
<td>-12.3</td>
<td>3.3</td>
<td>-3.3</td>
<td>-2.3</td>
<td>-1.3</td>
<td>0.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>Overall surplus/deficit</td>
<td>-7.3</td>
<td>-17.2</td>
<td>-2.8</td>
<td>-7.7</td>
<td>-6.5</td>
<td>-5.1</td>
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<tr>
<td>Total financing</td>
<td>7.3</td>
<td>17.2</td>
<td>2.8</td>
<td>7.7</td>
<td>6.5</td>
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<tr>
<td>External</td>
<td>4.4</td>
<td>1.6</td>
<td>6.6</td>
<td>2.5</td>
<td>4.8</td>
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<tr>
<td>Internal</td>
<td>2.9</td>
<td>15.5</td>
<td>-3.8</td>
<td>5.2</td>
<td>1.7</td>
<td>2.9</td>
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Memo  
GDP in millions of current Bs  

<table>
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<tr>
<td>Current revenue</td>
<td>7,462</td>
<td>8,856</td>
<td>10,394</td>
<td>12,136</td>
<td>14,274</td>
<td>17,974</td>
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Source: Elaborated with raw data from UDAPE.

Table 3  
Distribution of Central Government Expenditure by Sector, 1987–92  
Percent  

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<tr>
<td>Social sectors</td>
<td>32.7</td>
<td>35.5</td>
<td>27.3</td>
<td>22.2</td>
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<tr>
<td>Education</td>
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<td>22.9</td>
<td>18.2</td>
<td>15.7</td>
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<td>Health</td>
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<td>12.4</td>
<td>8.6</td>
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<tr>
<td>Urban affairs</td>
<td>0.2</td>
<td>0.1</td>
<td>0.6</td>
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<td>0.6</td>
</tr>
<tr>
<td>Other administration</td>
<td>67.3</td>
<td>64.5</td>
<td>72.7</td>
<td>77.8</td>
<td>76.5</td>
</tr>
<tr>
<td>Central government</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economic Development.
percent of GDP. Before reaching definite conclusions, however, more work is needed on the data. The accounting conventions often changed between 1987 and 1993. In addition, the numbers have to be reconciled, with the required adjustments, with the numbers in table 2, which show substantially higher values for the transfers of the NFPS.

<table>
<thead>
<tr>
<th>Year</th>
<th>Social sectors</th>
<th>Education</th>
<th>Health</th>
<th>Urban affairs</th>
<th>Other administration</th>
<th>Central government</th>
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<tr>
<td>1987</td>
<td>82.5 (Treasury)</td>
<td>11.5</td>
<td>94.1 (Total)</td>
<td>5.9 (Total)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>88.4</td>
<td>10.9</td>
<td>99.3</td>
<td>0.7</td>
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<tr>
<td></td>
<td>74.1</td>
<td>12.9</td>
<td>87.0</td>
<td>13.0</td>
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<tr>
<td></td>
<td>36.9</td>
<td>0.4</td>
<td>37.3</td>
<td>62.7</td>
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</tr>
<tr>
<td></td>
<td>87.3</td>
<td>7.6</td>
<td>94.9</td>
<td>5.1</td>
<td></td>
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<tr>
<td></td>
<td>85.7</td>
<td>8.9</td>
<td>94.6</td>
<td>5.4</td>
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<tr>
<td>1988</td>
<td>83.3</td>
<td>10.7</td>
<td>94.0</td>
<td>6.0</td>
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<tr>
<td></td>
<td>87.3</td>
<td>12.6</td>
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<td></td>
<td>77.1</td>
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<td></td>
<td>60.8</td>
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</tr>
<tr>
<td></td>
<td>86.8</td>
<td>8.7</td>
<td>95.5</td>
<td>4.5</td>
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<tr>
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<td>7.9</td>
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<tr>
<td></td>
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<td>0.0</td>
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</tr>
<tr>
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<td>98.2</td>
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<td>1.1</td>
<td>96.5</td>
<td>3.5</td>
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<tr>
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<td>96.3</td>
<td>3.7</td>
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<tr>
<td>1992</td>
<td>84.4</td>
<td>5.3</td>
<td>89.7</td>
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<td>92.7</td>
<td>4.2</td>
<td>96.9</td>
<td>3.1</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economic Development.
Bolivia and the Slowdown of the Reform Process

Table 5
Current Transfers from Central Government to Private Sector
Percent of GDP

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</tr>
</thead>
<tbody>
<tr>
<td>Pensions, donations, and prizes</td>
<td>0.83</td>
<td>0.72</td>
<td>0.68</td>
<td>0.58</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Pensions</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>0.57</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
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<tr>
<td>Donations and prizes to persons</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Scholarships</td>
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<td>0.01</td>
<td>0.01</td>
<td>0.04</td>
<td>0.03</td>
<td>0.02</td>
<td>0.02</td>
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<tr>
<td>Welfare aid</td>
<td>0.02</td>
<td>0.59</td>
<td>0.87</td>
<td>0.22</td>
<td>n.a.</td>
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<tr>
<td>Other subsidies</td>
<td>0.02</td>
<td>0.59</td>
<td>0.87</td>
<td>0.00</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total current transfers</td>
<td>0.86</td>
<td>1.32</td>
<td>1.57</td>
<td>1.42</td>
<td>0.58</td>
<td>0.64</td>
<td>0.68</td>
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</table>

n.a. Not available.

Source: Elaborated with data from the Ministry of Finance and Economic Development.

Statecraft in the Reforms

Initial Weakness of the Government
The government of Paz-Estenssoro started without a majority in Congress. The lack of a majority could have been a roadblock to reform. Although the Bolivian system is presidential, and usually the executive enjoys a large degree of autonomy, support in Congress is crucial for governance. In Bolivian history, democratic governments that have not paid attention to Congress have fared badly.

S.D. 21060 was hotly debated in Congress right after it was announced, but with the support of ADN, the main opposition party, the government won after a short period. In concert with the skirmishes in Congress, a confrontation in the streets was taking place. The riots and the strikes were not strong enough to overturn the government’s decisions, but the government clearly benefited from the public’s demand for stability. The combination of a severe economic and political crisis, the political will, and the acumen of President Paz-Estenssoro and Minister Sánchez de Lozada, created the government capacity to overcome all political obstacles to the reforms.

In a master political move, the MNR entered a pact with ADN, the party of former President Banzer, the so-called Pact for Democracy. ADN didn’t take cabinet posts, but it agreed to hold middle-level positions in the administration and in the SOEs. It is important to underscore that Paz-Estenssoro’s reforms would have been impossible without the support of ADN. Gamarra (1994, p. 107) notes that “the Pacto was one of the most significant attempts at institutionalizing a working arrangement between the government and the principal opposition party. In my view, this was key to ensuring the continuity of the NPE.”

The pact was crucial, not only for some of the reforms, such as the tax and budget reforms, but also in its contribution to blocking extended, debilitating hearings in Congress. The Bolivian tradition is that Congress, calling upon its oversight powers, permanently summons ministers for hearings. Taken to the extreme, the process can paralyze the executive.

President Jaime Paz-Zamora, emulating the Pact for Democracy, constituted the Patriotic Accord again with ADN, a former political enemy.

14 The acronym NPE stands for New Economic Policy in Spanish. NPE was the name given by the government to the package of measures in S.D. 21060 and the reforms that immediately followed.
The current government of President Gonzalo Sánchez de Lozada, although counting among its supporters a large number of senators and deputies, has also needed the support of other parties to strengthen its majority. It has formed the Pact for Governability.

The procedures for election of the president in the Bolivian Constitution force, in a multiparty system, the formation of coalitions or political pacts. Mayorga (1993, p. 335) asserts that “political pacts have become, in fact, the fundamental mechanisms of political stability and of the state governability since 1985.” Notwithstanding the trend toward a more parliamentary form, Bolivia continues to be strongly presidential. Since 1985 the discipline of the parties in government has been strong in Congress; it is very rare that the executive sees its proposals blocked.\(^{15}\)

The Bolivian democracy turns to a “delegative” democracy on the electoral and, to a greater extent, the congressional strength of the president.\(^{16}\) Once the president enjoys a majority in Congress, he feels entitled to govern as he sees fit, constrained only by existing power relations and by a constitutionally limited term in office. This differs only slightly from the characterization of O’Donnell (1994, p. 60): “The president is taken to be the embodiment of the nation and the main custodian and definer of its interests. . . . In this view, other institutions—courts and legislatures for instance—are nuisances that come attached to the domestic and international advantages of being a democratically elected president. Accountability to such institutions appears as a mere impediment to the full authority that the president has been delegated to exercise.” The government is run by the president and a coterie of trusted advisers. Still, in contrast with authoritarian regimes, the Congress and the press are free to voice their criticisms, and they sometimes make a dent in policymaking. Delegative democracy is not a permanent feature; rather, it is a recurrent phenomenon. The Paz-Estenssoro and Sánchez de Lozada governments are more of the “delegative” type, while Paz-Zamora’s was less so.

The most telling manifestation of “delegative democracy” in Bolivia is expediency, which is often is boasted of by the government as efficacy. Part of the pressure to implement adjustments rapidly, sometimes disregarding what is right, comes from the IFIs. In most cases the executive agrees with the IFIs to a set of reforms, without any previous consultation with Congress. Afterward, Congress is pressured to hastily approve the reforms. Dissident voices are silenced with the use of majority and strong party discipline.

The costs of governing this way should be apparent. Congressional approvals are rapidly won, but the acceptance by the public and the sustenance of the reform process are impaired. The probability of carrying out the reforms is reduced, as the discussion shifts from Congress and the press that covers it to the extra-parliamentary opposition and the press that opposes the reforms. The pedagogical value of discussions in Congress is lost, and extra-parliamentary opposition gets an undeserved boost, frequently by a lack of complete information, a lack that could have been avoided had more discussion taken place in Congress. In addition, there is a high probability of making gross mistakes through lack of sufficient attention to the pros and cons of the reforms. Finally, it concentrates all responsibility on the presi-

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15 The debate over whether the system has more features of a parliamentary system or a presidential one is not completely settled. Article 90 of the Bolivian Constitution grants to Congress the decisive power to elect the president of the republic if no candidate has obtained a majority in the popular elections. Congress chooses the president from among the three most voted candidates in the elections. According to Mayorga (1993, p. 336), this defines a strong parliamentary dimension to the constitutional system. At the same time, voters cannot chose the president, the vice-president, the senators, and deputies of different slates. This reinforces the presidential features.

16 The term delegative democracy was coined by G. O’Donnell. A full characterization is given in O’Donnell 1994.
dent, mortgaging his administration to the success of a handful of reforms.

**Businessmen and Technocrats in Power**

The government that launched the reforms in 1985 was formed, to a significant extent, by representatives of the business community. The Confederacy of Bolivian Private Entrepreneurs (henceforth, CEPB, the Spanish acronym), which had heately opposed the first democratic government, became the flag bearer of reform, despite the contradictions among its federated groups.\(^\text{17}\) In exchange for their support of the government, former top representatives of the CEPB entered the cabinet. The practice of incorporating business representatives into government somewhat diminished in the Paz-Zamora administration, but has surged again during the current government.

The seizing of ministries by representatives of the business community, as such, deserves attention. The main questions concern their role in the enhancement of governance. Have the businessmen-politicians brought with them some universal values and rules, and a healthy distrust of state’s encroachment, or have they directly captured the state for their own ends, without mediation, as they used to do?

Before answering the questions above let me mention that business has had to share power with a more traditional group: the technocrats. They are the most fervent reformers. They also share the language of the avidly courted IFIs: efficacy, efficiency, priority to macroeconomic management, liberalization, and privatization. Many of the technocrats have been educated in schools in the United States (up to master’s degrees), which obviously establishes a direct line of communication with their peers in the IFIs.

Even more to the point, very frequently the salaries of middle-level technocrats are paid with foreign aid funds.\(^\text{18}\)

The bipartite corporatism, established between the businessmen and the government’s technocrats, excludes organized labor (and the urban poor), which has given rise to criticisms among the intellectuals and in the press. It is indeed a potential source of political instability. Yet much of the current controversy over businessmen in high government positions does not focus on the potential conflict of interest between public functions and private undertakings, but rather on the failure of the businessmen-politicians to deliver the managerial skills that were expected. Especially with the administration of Sánchez de Lozada, there was quick disillusionment of the public regarding the government’s administrative capacity. The disappointment was not completely groundless. The public’s judgment was on efficacy in government, which was offered but not delivered. This would show that business competencies are not necessarily the best choice to run a smoothly functioning public administration. On behalf of the government, it must be said that the second-generation reforms are more demanding in skills than stabilization and the first reforms.

**The Weakening of Organized Labor**

The success of the stabilization program was in no small part the result of the weak state of the labor unions, which had been so powerful in earlier times. Their weakness was a by-product of their virulent opposition to all stabilization attempts of the Siles-Zúñiga government.

In a deft maneuver, the government of Paz-Estenssoro blamed the wage demands of orga-
nized labor as the main, if not the only, cause of the hyperinflation. This blatantly exaggerated contention was accepted by the public. When the government took strong action against the unions, it was applauded by many segments in the population. In an ironic twist, the public associated the labor unions with the Siles-Zuazo government and the leftist parties that supported it. Furthermore, the discourse of the labor leaders, impregnated with Marxist and Trotskyite rhetoric, seemed outmoded even in 1985. Doubtless, the unions paid the price of their excessive politization. They were disempowered under the new government, along with the other leftist groups that were important in the previous regime.

The labor unions retain some power to convince beyond their ranks because they represent the only organized opposition to what some Bolivians derogatorily call “neo-liberal” policies, and they command a nostalgic respect for their crucial role in the restoration of democracy. The unions have systematically opposed the reforms, and on occasion they have been able to block some of them, despite their weakness. Their power to block was brought about by a haphazard coincidence between their opposition and the public’s mood. Also, they have acted in a very opportunistic fashion, riding on issues that they perceived to be popular, even if they were unrelated to labor’s specific concerns. 19

Governance Capacity and the Second Generation of Reforms

This section presents three policy cases of governance capacity—or the lack of it. The first case relates to fiscal reform, which can be considered generally successful, even if its implementation is still incomplete. The other two cases—privatization and Social Security reform—have been significantly less fortunate. The deficits in governance capacity show very tellingly in these two reforms.

Governance Capacity and Fiscal Reform

With the liberalization of markets, the opening of the economy, and the pursuit of a restrictive monetary policy, the importance of fiscal policy has to increase. The strengths and weaknesses of the government will often show in the conduct of fiscal policy, understood in a broad meaning and including taxation and expenditure.

The problems of governance are to a large extent problems of fiscal governance. It is important to look at the conditions needed for the fiscal authority to implement the policy it has designed in a sustained manner, with a minimum cost in public resources and foregone investment expenditures, and without lowering public sector wages to a point where efficiency is impaired.

Most problems, some of them seemingly unrelated to the fiscal accounts, on closer examination are found to have important fiscal implications. From a political economy view, it is in the fiscal sector that most conflicts converge. It is also on the fiscal front where the reforms have been most successful relative to the other reforms.

The clearest tests of the governance capacity appear in the field of tax policy. The main questions concern the structure of taxation and the administrative efficiency in collecting them. A structure of taxes that falls on a broad base, and away from easy handles, such as taxes on foreign trade and fuels, would show governance capacity. Of course, the question of whether the government can collect the stipulated taxes is equally important.

19 For instance, the labor unions strongly supported the cocoa producers when the police forces took strong action against them at the beginning of 1994.
Tables 6 and 7 provide an illustration of the structure of taxes. Next to the collections of the Internal Revenue Services are the royalties and other transfers of the state-owned petroleum enterprise YPFB to the Treasury (tables 6 and 7). The transfers include both explicit taxes and hidden taxes, because much of the government revenue derived from the sale of fuels has not been legislated. Observe in table 7 that YPFB royalties and transfers are close to 40 per-

### Table 6
**Current Revenue of the National Treasury, 1988–92**
Percent of GDP

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td><strong>Total internal revenue taxes</strong></td>
<td>6.0</td>
<td>6.5</td>
<td>7.5</td>
<td>8.0</td>
<td>9.9</td>
</tr>
<tr>
<td>Value added tax</td>
<td>3.4</td>
<td>3.4</td>
<td>3.3</td>
<td>3.8</td>
<td>5.3</td>
</tr>
<tr>
<td>Specific consumption tax</td>
<td>0.4</td>
<td>0.7</td>
<td>0.6</td>
<td>0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>Tax on transactions</td>
<td>0.6</td>
<td>0.6</td>
<td>1.1</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Income taxes</td>
<td>0.7</td>
<td>0.8</td>
<td>0.9</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Estimated corporate profits tax</td>
<td>0.3</td>
<td>0.4</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Complementary tax to VAT</td>
<td>0.5</td>
<td>0.5</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>Other internal revenue taxes</strong></td>
<td>1.0</td>
<td>1.0</td>
<td>1.6</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td><strong>YPFB royalties and transfers</strong></td>
<td>4.4</td>
<td>4.9</td>
<td>4.3</td>
<td>6.4</td>
<td>5.7</td>
</tr>
<tr>
<td><strong>Mining royalties</strong></td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Custom duties on imports</strong></td>
<td>1.4</td>
<td>1.1</td>
<td>1.0</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Non-tax revenues</strong></td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total current revenue</strong></td>
<td>12.0</td>
<td>12.8</td>
<td>13.0</td>
<td>15.4</td>
<td>16.8</td>
</tr>
</tbody>
</table>

*Source: Elaborated with data of the Ministry of Finance and Economic Development.*

### Table 7
**Structure of the Current Revenue of the National Treasury, 1988–92**
Percent

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total internal revenue taxes</strong></td>
<td>50.4</td>
<td>50.8</td>
<td>57.9</td>
<td>51.9</td>
<td>58.9</td>
</tr>
<tr>
<td>Value added tax</td>
<td>27.9</td>
<td>26.6</td>
<td>25.7</td>
<td>24.4</td>
<td>31.7</td>
</tr>
<tr>
<td>Specific consumption tax</td>
<td>3.7</td>
<td>5.2</td>
<td>4.5</td>
<td>5.1</td>
<td>5.0</td>
</tr>
<tr>
<td>Tax on transactions</td>
<td>4.7</td>
<td>4.9</td>
<td>8.5</td>
<td>8.8</td>
<td>9.0</td>
</tr>
<tr>
<td>Income taxes</td>
<td>6.2</td>
<td>6.5</td>
<td>6.6</td>
<td>6.2</td>
<td>6.1</td>
</tr>
<tr>
<td>Estimated corporate profits tax</td>
<td>2.3</td>
<td>2.9</td>
<td>3.3</td>
<td>3.1</td>
<td>3.0</td>
</tr>
<tr>
<td>Complementary tax to VAT</td>
<td>3.9</td>
<td>3.6</td>
<td>3.4</td>
<td>3.1</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Other internal revenue taxes</strong></td>
<td>7.9</td>
<td>7.6</td>
<td>12.7</td>
<td>7.4</td>
<td>7.0</td>
</tr>
<tr>
<td><strong>YPFB royalties and transfers</strong></td>
<td>36.8</td>
<td>38.6</td>
<td>33.5</td>
<td>41.7</td>
<td>33.9</td>
</tr>
<tr>
<td><strong>Mining royalties</strong></td>
<td>0.6</td>
<td>1.1</td>
<td>0.6</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td><strong>Custom duties on imports</strong></td>
<td>11.3</td>
<td>8.9</td>
<td>7.5</td>
<td>5.8</td>
<td>6.2</td>
</tr>
<tr>
<td><strong>Non-tax revenues</strong></td>
<td>1.0</td>
<td>0.6</td>
<td>0.4</td>
<td>0.4</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Total current revenue</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

*Source: Elaborated with data of the Ministry of Finance and Economic Development.*
cent of the total current income of the National Treasury.

There are no studies of incidence across income categories after the reform, but the presumption is that the structure is at best neutral, and more likely, regressive. Most taxes are of the indirect kind. Moreover, taxes on fuels have a disproportionate weight in total collections. High incomes are clearly taxed at a low rate in the international context. Yet the question of whether the current tax structure is more regressive than the previous one is difficult to answer if evasion is considered. While in principle the tax structure before the reform of 1986 was progressive, generalized evasion in the private sector probably turned around the feature. The current tax system seems less prone to evasion.

A major institutional change in the administration of public resources is given in Law 1178 of July 1990, which governs the administration and control of the public accounts (henceforth, SAFCO, for the Spanish initials with which it is known). The SAFCO law and the budgetary process described below are the offspring of the consensus of virtually all political parties on the need for fiscal correctness. The whole idea was to establish a system of checks and balances conducive to the goal of having low deficits and the best use of public resources.

The SAFCO law is comprehensive and takes a systems' approach to tackle the problems of programming of operations, accounting procedures, organization of the administration, budgeting, treasury operations, internal and external audits, and ex-post control of the public sector accounts. The SAFCO law completes the legal framework for budget formulation and execution, given mainly in the Bolivian Constitution.

All budgetary activities, except the ex-post control, are in the different undersecretariats of the Ministry of Finance. The ex-post control is in the extremely powerful General Comptroller's Office ("Contraloría General de la República"). The "Contraloría" is an office, independent of the executive branch, and accountable only to Congress. The general comptroller is appointed for a term of ten years. In principle and in actuality, the Contraloría is immune to the influences of political and interest groups. It is the supreme judge of fiscal propriety.

An important innovation of the SAFCO law is that all public servants, regardless of position in the bureaucratic hierarchy, are fully responsible for their decisions and are accountable not only for the resources that were entrusted to them, but for the results and the use of these resources. This implies that public servants could be prosecuted not only for malfeasance, but also for errors of judgment or professional malpractice.

The SAFCO law has increased the sense of responsibility in the bureaucracy, but it also has caused unwarranted delays in decisionmaking. The law has not prevented the petty corruption of low-level employees, but it is feared by high-level officials, and consequently has the potential to stop the most harmful cases of abuse of public resources.

The draft budget goes through several filters in the executive. The project is discussed in the Cabinet of Ministers, where late changes can still be made. Once the project is approved in the Cabinet of Ministers, it is sent to Congress.

When the draft budget is received in Congress, it is then discussed in committees and in plenary sessions (see figure 2 for a picture of the process). Once approved by the Chamber of Deputies and the Senate, the budget is sent back to the executive, which promulgates it as law. It is readily seen that the final version of the budget results from a delicate system of checks and balances between the executive and the legislative. The process is cumbersome, but it has the advantage of precluding major mistakes.

The president could, in principle, veto the budget, but this has never been done. Congress is usually cautious in modifying the draft sent by the executive without its agreement. Neither
the executive nor Congress would find it profitable to enter into a conflict of powers. This acts as a deterrent to Congress should it wish to amend the draft unilaterally. Congress has a deadline to approve the budget; if it does not meet the deadline, the executive’s draft automatically becomes law.

During the preparatory phase in the executive, and while in Congress, the government negotiates with the main interested parties, mainly the labor unions, the regions, and the public universities. Negotiations with the regions, which primarily involve the public investment budget, are conducted with local authorities and are particularly concerned with the views of the so-called “civic committees,” associations of local interests involving business and labor groups, community associations, and private persons, usually retirees. In some regions, civic committees are very powerful.

A feature of the Bolivian budgetary process is the very significant amount of social and politi-
cal unrest in the first quarter of each year, right before the budget is presented to Congress and while it is there. The wage guidelines in the draft budget trigger the reaction. Claims on the budget are sometimes introduced by violent means: street riots, general and hunger strikes, road blockades, and so on. The budget process becomes the focus of political activity during these months.

The upheavals illustrate the importance of the budget and how binding it is. At the same time, the budget is not fully immune to political pressure, and often the expenditure allocations are higher than a controlled deficit would warrant. This has caused parallel or shadow budgets, negotiated with the other major player, the IMF. Actual disbursements of the amounts budgeted by Congress follow the accords between the executive and the IMF.

Problems with Privatization and Social Security Reforms

Most of the pending second-generation reforms have met strong hostility, but the greatest challenges have been to privatization and Social Security reform. I will concentrate on these.

Although almost everybody has a complaint about the functioning of the public enterprises, the private enterprises do not fare better, especially in the services sector. The latter, having been sheltered from foreign competition for years, more because of natural barriers than as a result of policy, offer services that are as poor or poorer than in the public sector. To some, privatization is yet another form of corruption to favor the cronies of top officials.20

Also, it should be recognized that there is a deep distrust of the traditional Bolivian private entrepreneurs in Bolivian social and political culture. Race and social considerations are not absent in the suspicion: many among the traditional entrepreneurs are of the white and whitened, mixed-blood upper classes, with a history of privileged access to public resources. The hard lobbying of the CEPB for privatization has been counterproductive in many ways. Had the CEPB stayed out of the debate, opposition to privatization probably would have lost steam.

Organized labor’s opposition to the reform of the Social Security system is even stronger than to privatization. Why, given the blatant deficiencies of the Social Security system, is there such resistance to reform? A partial answer is that the reform of the pension system through individual capitalization, instead of the current system of “pay as you go,” is seen as contradicting the deeply ingrained value of solidarity.21 Also, workers resent that the government will decide on their saving, without consulting them. There is also a problem with the packaging of the measure. It has been presented by government as if the creation of a large capital market were the only objective.

The failure to obtain progress in privatization and Social Security reform would suggest that the initial strength of the government, gained after its success in controlling hyperinflation, has suffered erosion. Two explanations may be given for this. The first requirement of governance, at least initially, is a “vision.” Structural adjustment, in its Bolivian incarnation, tried to mobilize society around “engineering” values, such as efficiency and the optimal allocation of resources, while ignoring more traditional values in the political culture, such as solidarity and common destiny. This agenda was too narrow.22

Second, the slowness in the resumption of growth has affected the public’s assessment of the

20 The first privatizations were, to say the least, controversial. For instance, a sugar mill was sold in an auction for US$10 million. One year later, a private mill similar in fixed assets and technology to the privatized mill is offered for sale for US$36 million.

21 Solidarity in the Social Security system is enshrined in the Bolivian Constitution.

22 The need for “self-reliance,” a liberal value, could have been shared by many. That point was not emphasized in the official discourse, perhaps because this argument would have been seen to be at odds with governments that were more dependent on foreign aid than ever before in the history of Bolivia.
reforms. Contrary to what happened with stabilization, when the sharp drop in inflation and the increase in welfare were almost immediately felt, the public doesn’t yet see concrete and significant improvements in employment, real wages, or the quality of the social infrastructure. As a result, public opinion has become apathetic toward the reforms and the most visible institutions: all branches of government, the bureaucracy, the political parties, the business associations, and the labor unions.

The sporadic veto power of small and unrepresentative groups needs some explanation. Unfortunately, only conjectures can be provided now. One idea is that there is a lack of conviction in the government itself on the merits of the reforms. On many issues the economic teams have been divided, and the opposition of any small group outside government has been taken as an excuse for inaction.

Regarding privatization and Social Security reform, top officials in the government have hesitated to take measures that may be politically attacked as favoring a privileged group of people. Even if the now reluctant factions in government eventually agree on the reforms, they will proceed very slowly and with extreme prudence.

There is also a problem with the packaging of the policies. The case for reform has been argued to date through historical comparisons (always referring to the hyperinflation of 1982–85), with arguments that are contradicted by evidence (for example, that all SOEs lose money), or because all our neighbors are doing the same. The government’s messages are recast by the opposition as if the benefits of the reform were only for particular interest groups. Little use has been made of the compelling argument that without the reforms the country risks being left without saleable products in world markets, with evident losses of welfare.

The polls reveal that the proposal of popular participation enjoys wide acceptance in the public. It indeed has the potential to mobilize society and stir some enthusiasm for the reforms. Yet while popular participation is undisputed, this doesn’t imply that there are broad coalitions that would stand for it should a movement to reverse the measure appear.

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23 See the opinion polls of the Catholic University of Bolivia, in Salinas 1994.
Concluding Remarks

The purpose of this chapter was to show in detail how the dynamics of the first generation of reforms have been very different from those of structural adjustment in the Bolivian experience. The implementation of the stabilization policies and the first reforms showed considerable statecraft. In contrast, later initiatives for more complex structural adjustments have met little success.

The first generation of reforms have left important legacies. There is now a consensus in the main political parties on some basic points: first, the need to maintain price stability; second, not unrelated to the first point, the need to keep deficits low and to allocate the scarce public resources primarily to spending in the social sectors; and third, but less forcefully, the need to transform the economy into a market economy, without forsaking equity.

Based on this legacy, the second generation of reforms could have proceeded more smoothly than has been the case. One nevertheless can be optimistic on their chances of implementation in the future if a more flexible approach is taken, both by the government and the IFIs. One can foresee many tests in the coming years on the governance capacity to promote further reforms.
Bibliography


Successful Adjustment and Declining Governance? The Case of Egypt

Saad Eddin Ibrahim and Hans Lofgren

Throughout the 1980s, the Mubarak administration postponed any effective initiative of economic reform, while Egypt, like many other developing countries, struggled with the chronic economic ills of severe budget and trade deficits; high inflation; a huge, inefficient public sector; and heavy external debt. By the end of the decade, Egypt's inability to service its debts was the most dramatic of several danger signals.

The government's reluctance to initiate an economic reform and structural adjustment program (ERSAP) was finally overcome in 1990–91 by a host of regional and international factors, including the direct and indirect financial rewards for Egypt's role on the side of the International Coalition in the Gulf Crisis (1990–91) and the promise of canceling a substantial part of the country's external debt. The program was formally ratified in May 1991 through agreements with the IMF and the World Bank, and it has been set in three phases. The first two (1991–93) have been judged by both international institutions as fairly successful, while the third phase is still under way.

Nevertheless, the government did not manage to organize a strong support constituency for the program, either among the immediate beneficiaries of the changes (primarily businessmen) or in society at large. Even political parties that, in principle, could be expected to welcome the reforms have voiced their dissent over the government's handling of the policy changes. Major opposition parties boycotted President Mubarak's reelection to a third term in October 1993. Labor unrest in the public sectors escalated steadily in 1993 and 1994. At the end of 1993, more than half of Egyptians (sampled in a national survey) felt that their life had deteriorated since the preceding year; two-thirds said it had deteriorated compared with five years earlier. This period brought an acute increase in the political isolation of the government. Widespread dissatisfaction went beyond the economic policies.

During the first three years of ERSAP (1991–93), Egypt witnessed an unprecedented wave of politically motivated violence, mainly between Islamic activists and the state. While economic reform is not an explicit target of this violence, both the time coincidence and the concentration of the violence in the country's most socioeconomically depressed areas cast doubt on the governance capacity of Egypt's ruling elite, and should be seen as a matter of concern to the future of the economic program.

Most of the discontented Egyptians are among the short-run "losers" of ERSAP, which reinforces
Governance, Leadership, and Communication: Building Constituencies for Economic Reform

this concern, and include the lower and lower-middle classes (over 75 percent of the population). The most vulnerable of the losers are: (a) the young, educated, and unemployed; (b) the workers and white-collar employees of the public sector and civil service; and (c) the rural and urban poor and those dependant on fixed incomes, whose basic needs are largely fulfilled by subsidized goods and services.

The survival of the regime itself is not at stake; its capacity at the international level has been impressive, and the upsurge of domestic violence, still limited to small numbers, does not pose a threat to order. Some key governance shortages, however, must be rectified. Although Egypt’s ERSAP thus far has proceeded with inadequate governance capacity, it is doubtful that it can continue on the same basis. The program will require increased support in society and active cooperation from both the state bureaucracy and key economic agents. The shortage of political capacity has forced the state to rely disproportionately on its coercive capacity, leading to its growing political isolation. Thus, most important among the governance shortages to be addressed are the severe credibility-legitimacy-effectiveness gap, a deeply alienated civil society, and the consequent sluggish democratization process.

The Egyptian case provides theoretical and substantive material in support of this research project’s main hypotheses (Atiyas and Frischtak 1993): that positive adjustment may be contingent on effective design and political articulation of a national project that convincingly translates immediate losses into future benefits (material and nonmaterial). One important factor underlying some of the governance shortages in Egypt has been the lack of such a project, or vision, which could have allowed society to understand and relate to government’s policies in a more positive way, rather than just to endure the costs. In a country that had been home to two powerful visions in the past, Mubarak’s personal reluctance and insufficient efforts to provide such a vision left a gap that could be filled by alternative visions, such as that of the Islamic movement.

To set the stage for Egypt’s ERSAP, a brief review of the country’s socioeconomic performance and its modes of governance during the previous four decades (1952–91) is needed. This account provides a baseline for the visions accompanying both President Nasser’s quest for a “socialist transformation” (1952–70) and President Sadat’s quest for an “open society” (1970–81). Sadat’s administration served as a prelude to Egypt’s ERSAP under Mubarak some ten years later. The nature of the tradeoffs in the competing visions of Nasser and Sadat had become integral parts of Egypt’s socioeconomic landscape, political culture, and collective consciousness. Mubarak attempted a synthesis of these views in his first ten years in office (1981–91). Since 1990, however, he has clearly been tilting toward his own version of Sadat’s vision with ERSAP.

Nasser’s Vision

Along with some one hundred officers, Nasser led a military coup d’état on July 23, 1952, against the royalist regime, which had been perceived by most Egyptians as alien, corrupt, and decadent. He presided over the Free Officers and the Revolutionary Command Council (RCC). This coup evolved into a full-fledged revolution, which was soon positively received by most Egyptians. With its drastic agrarian reform measures (September 1952), dissolution of political parties, abolition of the monarchy, declaration of the Egyptian republic (1953), agreement forcing the British to evacuate the Suez Canal Zone (1954), and setting up of national bodies for streamlining and energizing production and services (1954), Nasser’s Free Officers trans-
formed their coup into a full-fledged revolution (Ibrahim 1978).

Nasser's July Revolution, as it came to be called, compiled an impressive list of achievements: resisting Western military pacts, championing the Non-Alignment Movement (NAM), furthering Pan-Arabism, and instituting ambitious socioeconomic development plans. By 1960–61, the revolution had nationalized most of Egypt's large- and medium-scale economic enterprises, effected another land reform (further reducing maximum ownership from 200 to 100 acres of land for each family), instituted urban housing rent control, and provided free education and health services. These and other measures had vast redistributive effects in favor of the middle and lower classes in urban and rural areas alike. Together these programs were dubbed "socialist transformation," "Arab socialism," or the "Arab application of socialism" (Ibrahim 1978).

With increasing political controls, restricting basic freedoms and human rights, and nominally running the country through a single party (the Liberation Rally, then the National Union, and finally the Arab Socialist Union, ASU), the regime had all the marks of a developing-country "populism." With Nasser's charisma, marked socioeconomic achievements, and regional and international preeminence well into the late 1960s, this populist formula seemed acceptable to a vast majority of Egyptians. It was a "social contract" that satisfied basic needs, consolidated a sense of social equity, opened the doors for social mobility through meritocracy, and afforded the people pride and dignity as Egyptians and as Arabs. The decade of 1955–65 witnessed a remarkable rate of investment, averaging 17.0 percent, and an equally impressive rate of economic growth, about 7.0 percent annually. Egypt's total civilian debt in 1970 (on Nasser's death) was $1.7 billion, most of which went toward financing the Aswan High Dam and other industrial projects of the first Five-Year Plan (1960–65) (Amin 1994). All young Egyptians were guaranteed jobs and salaries that would enable them to find housing, start a family, and live decently, though modestly (Ibrahim 1982a).

The foreign policy of Nasser's populist regime served its overall purpose. In the height of the Cold War years (1950s and 1960s), the regime managed to play a balancing game between the two blocs and to exact the maximum amount of foreign aid from both to finance its ambitious development plans—the Aswan High Dam, industrialization, and an ample wheat supply for the country (Abdel-Khalek 1982). Although steadily tilting toward the Soviets, the regime maintained a credible posture of independence and neutrality in international forums. It also maintained—both in word and in deed—its support and espousal of liberation movements in the Arab, African, and developing countries. Although he created many enemies among Western and pro-Western conservative regimes in the Middle East (for example, Turkey, Iran, and Saudi Arabia), Nasser enjoyed widespread popular support in the region and beyond (Kerr 1971).

Nasser's populist regime offered a vision and a set of credible policies that ensured smooth governance for at least fifteen years. Nevertheless, the stunning military defeat at the hands of Israel in 1967 raised serious questions about the regime's vision and its policies at home and abroad. Between his defeat (1967) and his death (1970), Nasser began revising both his vision and state policies. Elements of such a revision were foreshadowed in a public document known as the "March 1968 Declaration." The people and the leadership, however, were too absorbed preparing a new war of liberation against the Israeli occupation to put the declaration into effect. His successor, President Sadat, would implement the changes, and in the process he would de-Nasserize Egypt.
Sadat's Vision

Nasser's death in September 1970 was a source of profound grief, both in Egypt and throughout the Arab World. His successor, President Sadat, did not appear charismatic, resourceful, or forceful. To consolidate his power base and to enhance his legitimacy, Sadat vowed to hold to his predecessor's legacy and to carry on the war of liberation against Israeli occupation. In October 1973 he staged a successful war, which was hailed by the powerful state media as the "October Victory." Feeling more confident, Sadat issued the "October Paper," which included elements of what would be a vision of his own, although it invoked Nasser's "March 1968 Declaration" as its preface. During the following four years, these elements became a full-fledged socioeconomic-political project, which lasted until Sadat's assassination in October 1981.

Of greatest relevance to our concerns here is that the economic element of Sadat's new vision was the first to be announced and implemented. As with the other elements of his program, Sadat presented it in a token homage to Nasser, asserting that his predecessor would have blessed it, because the policy had been contained in the "March 1968 Declaration" (Ibrahim 1993a). The economic component of the new Sadat vision was debated, deliberated, and finally formulated into a policy in early 1974, under the title of "Infitah," or "Open-Door Economic Policy" (ODEP).

ODEP was embodied in Law 43 of 1974, which was designed to encourage private investments, initially Arab and foreign capital, but ultimately Egyptians' funds as well (Law 32 of 1977). It also provided for foreign banks to establish branches in Egypt or to enter into joint banking ventures with their state-owned counterparts. Import-export and currency regulations were markedly liberalized. Egyptians could open accounts in foreign currencies, and remit and transfer without any questions asked (Ibrahim 1993a). Aided by regional developments, mainly the skyrocketing oil prices that followed the October 1973 war, and the resultant rising revenues of Arab oil-exporting countries, ODEP was in many ways quite timely. Millions of Egyptians migrated to the oil-rich countries; they earned, saved, and remitted billions of dollars from the mid-1970s onward (Ibrahim 1982a). Oil-rich countries or their respective development funds also extended grants and loans to Egypt. An estimated $3.0 billion annually poured into Egypt from these two sources alone. Western foreign aid, especially from the United States, averaged about $2.0 billion a year. The annual rate of growth was estimated to be around 8.0 percent of gross domestic product (GDP) during 1975-81 (Amin 1994).

ODEP was clearly intended to transform Egypt into a more outward-looking, market-capitalist economy. The private sector was to be given a forceful push on par with, or even at the expense of, the huge public sector inherited from the Nasser years. ODEP was initially well received by the vast majority, including the working classes, whose members looked forward to the new opportunities to be found both at home and in neighboring Arab countries (EFLU 1992). More sustained enthusiasm for ODEP would come from the upper and upper-middle classes—the older, landed bourgeoisie; professionals who made fortunes abroad; and senior or retired managers of the public sector eager to move onward and upward. The early years of ODEP also witnessed the sprouting of a new class of businessmen, entrepreneurs, agents, and brokers for foreign corporations. This group would become an additional and substantial constituency for Sadat's ODEP, and it would collaborate with and marry into the older upper classes (Ibrahim 1993a).

Along with ODEP, Sadat's vision included three other policies. The first was a limited political opening toward a more pluralistic democratic
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Society, with the promise of more to come. Initiated in 1976, multiple forums were first permitted within the single party inherited from the Nasser years, the ASU. Soon after (1977), a multiple-party system was reinstated for the first time since 1952. Although restricted to three, then five, parties, including Sadat’s own,1 most Egyptians welcomed this new political pluralism. It seemed well-suited to the new economic liberalization, but it was also an overdue response to a demand of Egypt’s middle classes (Ibrahim 1993a). The new parties were allowed to publish their own newspapers and to compete in elections in 1976 and 1979. Even the Muslim Brotherhood, banned since 1954, was allowed to operate de facto and to issue publications. All the opposition parties took the matter seriously, and the regime’s policies were heatedly debated and criticized.

The opposition parties, however, complained of irregularities in elections and a lack of fairness in access to the electronic media (radio and television), which remained a state monopoly and for the almost exclusive use of the National Democratic Party (NDP), headed by Sadat. By 1979, President Sadat began to display signs of impatience with the opposition parties, especially their disagreement with his peace initiative with Israel and the growing linkages with the West. In the 1979 parliamentary elections, none of the major opposition parties won a single seat. Growing segments of the Egyptian public lost faith in the regime’s commitment to democratization. By September 1981, the margin of open, legal dissent had greatly diminished. Several opposition figures were arrested and detained without formal charges between September 3 and September 5, 1981.

The other two elements of Sadat’s vision were related to foreign policy. Immediately after the 1973 October War, the Egyptian regime grew steadily closer to the West, especially the United States. This was clearly a strategic shift after twenty years of close relations with the Soviet Union. Sadat had deliberately cooled those relations as early as 1972, when he expelled some 20,000 Soviet experts from Egypt (Ibrahim 1993a). Egypt resumed its diplomatic relations with the United States and started receiving aid following President Nixon’s visit in the spring of 1974. By the late 1970s, Egypt would become the second-greatest recipient of U.S. aid, after Israel. The U.S. Agency for International Development (USAID) mission in Cairo also grew to become the largest such mission in the world (Abdel-Khalek 1982).

Closely related to this strategic shift in global alignment from East to West was President Sadat’s reconciliation with Israel. Following the 1973 war, Egypt signed a number of disengagement agreements with the Jewish state. But it was Sadat’s historic journey to Israel in November 1977 that would decisively pave the way to a historic compromise between the two countries. Two accords were signed at Camp David in 1978, followed by a full-fledged Peace Treaty in 1979. This brought an end to a thirty-year state of war between the two countries (Ibrahim 1993a). Much of the Arab World was alienated by these swift developments. Egypt’s membership in the Arab League was suspended; the League’s headquarters were moved from Cairo to Tunis; Arab governmental aid to Egypt was stopped; and diplomatic relations with Arab countries (except Sudan and Oman) were severed. Western aid was increased to make up for the loss, however, and Egyptian laborers in the oil-rich Arab countries and their remittances were not markedly affected.

All in all, Sadat had managed to package and propagate a vision that was dazzling to most Egyptians. It promised a more open economic system and democratization at home, closer ties with the

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1 These were Egypt’s Party, and later the National Democratic Party (NDP), presided over by Sadat himself and presented as a “centrist” party; the Liberal Party (LP), presented as “rightists;” the Progressive Unionist Party (PUP), presented as a “leftist” group; the Labor Socialist Party (LSP), presented as left-of-center; and the New Wafdi Party (NWP), presented as right-of-center.
"advanced West," and regional peace. These policies were promoted by a powerful state media as the vehicle to put an end to the suffering of Egyptians from war and deprivation, and as paving the way to progress and prosperity. Most Egyptians were initially receptive to this vision. Toward the end of the Sadat years, however, they became disillusioned, frustrated, and alienated. The massive food riots of 1977—when the government, on the advice of the IMF, announced the reduction of subsidies to some basic commodities—were an early warning that more trouble was to come (Amin 1982). Although the army was called in to put down the riots and the subsidies were restored, Sadat would not reverse his course; most Egyptians sensed that the legacy of Nasser's egalitarianism had truly gone (Ajami 1982).

On October 6, 1981, while attending a military parade celebrating the eighth anniversary of the “October Victory,” President Sadat was assassinated by a group of the same soldiers he was proudly reviewing. The four years separating the food riots and the assassination witnessed accumulating signs that Sadat’s vision was quickly losing its appeal for most Egyptians. Despite the huge flow of foreign aid and remittances, Egyptian external debt had skyrocketed from less than $5.0 billion in 1970 ($1.7 billion civilian debt and an estimated $3.3 billion in military debt), when Sadat ascended to the presidency, to about $30.0 billion in 1981, when he was killed (Amin 1994). The seeds of the mounting Egyptian civilian debt were sown in the 1970–75 period, when it jumped by 350 percent (from $1.7 to $6.3). The annual rate of growth of Egypt’s debts in those five years was 23.0 percent, compared with only 9.0 percent in the 1960s (Amin 1994). Tales of corruption among officials in high circles, including members of Sadat’s own family, had become rampant. Social equity had worsened. The lower-middle and lower classes found their circumstances increasingly strained, as they witnessed the nouveau riche flaunting their wealth, thanks to ODEP. Although most Egyptians had not been happy in the late Nasser period, they now lamented those years with nostalgia.

Introduction to the Mubarak Period

Most Egyptians were torn between the contrasting legacies of Nasser and Sadat, as was the newly elected President, Hosny Mubarak. When Mubarak took over, he was cognizant of the heavy burdens inherited from his predecessors. The heaviest of those burdens was Egypt’s economic dilemma. Early in 1982, he convened an economic conference of the country’s most renowned economic and political figures. They deliberated for three days, and made several policy recommendations for reforming and revitalizing an ailing economy—curbing imports, reducing the military budget, rationalizing investments, and reducing external borrowing (Amin 1994). According to Egyptian economist Galal Amin, however, “few if any of these recommendations were sincerely followed. Instead, the policies after 1981 remained essentially an extension of those of the 1970s” (Amin 1994, p. 32).

The reluctance of the regime to act on the policy recommendations was attributed to both Mubarak’s extremely cautious style and the emboldened leftist opposition, hostile to economic reform along IMF–World Bank lines. On the one hand, in contrast with his predecessors, Mubarak seemed particularly disinclined to embark on yet another effort at vision-policy orientation. On the other hand, his ambivalence toward the policy changes themselves was undeniable; it stemmed from his perception of the potentially high political costs and uncertainty that these changes entailed, most probably supported by memories of the food riots.
The result of such reluctance was a rapid accumulation of external debt during the next nine years (1981–90), from $30.0 to 48.0 billion, about 150.0 percent of Egypt’s GDP, the highest in modern Egyptian history (Amin 1994). Several noted Egyptian economists sent loud warnings from the mid- to the late 1980s, adding that further delay in implementing economic reform would make things worse for the rulers and the ruled alike, and that the inevitable ERSAP would be more costly (Shihata 1987).

In the following section, we will review the unfolding Egyptian economic crisis of the 1980s, which compelled the regime to embark in 1991 on what it had been unwilling to do since 1981. The irony is that the first term of Mubarak’s presidency (1981–87) were the years of the regime’s optimum governance capacity. There was ample goodwill toward the new president, and few acts of violence or sociopolitical unrest. Domestically, those early years would have been the most promising for the introduction of ERSAP. By the time it was finally done (1991), much of the public goodwill had diminished, and the regime’s capacity had eroded. Mubarak’s first term was one of political dynamism and economic stagnation. By the time ERSAP was initiated, the country had already been suffering from six years of political stagnation, which has continued well into the 1990s. This lack of synchronization between the political and the economic has had serious adverse effects on Egyptian society—violence unprecedented in its modern history (since 1897).

Economic Reform: Underlying Causes and Government Discourses

The government decision to implement a relatively orthodox economic reform program in the early 1990s may be explained with reference to Egypt’s economic performance in the preceding period, economic and political changes in the international arena, and domestic politics. The more precise timing of the policy shift was strongly influenced by the economic conditions toward the end of the Gulf War: an expected economic upturn and a comfortable foreign exchange situation increased the political feasibility of the economic reforms.

Egypt’s Economic Performance in the 1980s

Toward the end of the 1980s, it had become clear that the economic policy package of the 1980s was unsustainable in the long run. In the years immediately following the adoption of the open-door policy (1974), Egypt’s earnings from its major sources of foreign exchange (foreign aid, tourism, the Suez Canal, worker remittances, and oil exports) grew rapidly, inducing strong growth in the domestic economy. Between the mid-1970s and the mid-1980s, the Sadat-Mubarak regime continued a portion of Nasser’s populist policies, including large-scale subsidies for basic goods and services (especially food and energy), mass employment of secondary-school and college graduates in the state bureaucracy, urban rent control, agricultural crop and price controls, and an inefficient and heavily subsidized public sector. The growing imbalances in Egypt’s external trade and state budget were financed by foreign exchange. As long as these funds were easily accessible, it was possible to paper over the structural deficiencies in the economy.

Under the more adverse (but probably more normal) external conditions that have prevailed since the mid-1980s, GNP per capita fell by 10 percent (from $670 in 1986 to $610 in 1990), while the real wage per worker declined by 14 percent.

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2 The previous high was in the 1880s, when external debts were estimated to be equal to 100.0 percent of Egypt’s GDP.
between 1986/87 and 1990/91. At the same time, unemployment continued to grow, reaching 15–20 percent, perhaps twice the level of the mid-1970s. Between the mid-1970s and the late 1980s, some 70–90 percent of all new jobs came from emigration and government employment, two areas in which future expanded employment seemed unlikely.\(^3\)

In its dealings with the outside world, Egypt’s economic performance had also been bleak. Between 1980 and 1989, the foreign debt increased from $20 billion to $49 billion \((\text{World Bank 1991})\), revealing that the “rents” earned from oil and the country’s strategic position were insufficient to maintain an acceptable external balance. At the time of Iraq’s invasion of Kuwait, the country’s debt arrears (unpaid principal and interest on foreign loans) amounted to some $10 billion \((\text{The Economist, April 6, 1991; MEED, May 31, 1991})\). There was no reason to expect any significant improvements.

The revolutions in Eastern Europe made the long-run expectations for future foreign exchange inflows even gloomier: the elimination of the West’s main political protagonist threatened to reduce the long-term ability of countries such as Egypt to bargain for aid. Suggestions in early 1990 that the United States should reallocate some of its foreign aid from the Middle East (Egypt included) to Eastern Europe confirmed such fears \((\text{al-Ahram, October 26, 1991, p. 5; Springborg 1990})\).\(^4\)

All these events suggest that the policy package of the 1980s was not sustainable. Falling real incomes and rising unemployment threatened to produce exactly what some feared would be the result of orthodox economic reforms: riots and political instability. On the international stage, Egypt was turning into an eternal beggar for debt forgiveness and emergency loans. In 1990 the International Development Association (IDA), the World Bank affiliate that provides soft loans to the world’s poorest countries, reclassified Egypt as belonging to this group, a symbol of the country’s deteriorating status \((\text{Sherif 1990})\).

### Economic and Political Changes in the International Arena

The late 1980s saw the rejection of a state-led economy in Eastern Europe and the overthrow of most of the governments that had pursued this path. It also appeared that developing countries with dominant private sectors—most important, a group of Southeast Asian countries—had been more economically successful than others. The resulting international ideological atmosphere was summarized as follows in *The Economist* (October 12–18, 1991, p. 21): “In the past few years a new consensus on economic policy has emerged. In many respects this consensus looks a lot like ‘Bank/Fund orthodoxy.’ This change has gone so far that, increasingly, the Bank and the IMF find their borrowers running ahead of their advice in both the scope and pace of economic reform.” Following this trend, in his speech on May Day 1991, Egyptian President Mubarak came out as a supporter of the IMF and the World Bank, in contrast to statements in the late 1980s, when he compared the IMF to a quack doctor prescribing fatal doses of medicine \((\text{al-Ahram, May 2, 1991; MEED, December 6, 1991; The Middle East, July 1989})\). For Egypt, close relations with the West in general, and the United States in particular, since the mid-1970s had reinforced the new, more fa-

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\(^3\) Data are based on the following sources: World Bank 1993a (p. 233; GNP growth); CAPMAS 1993 (p. 310) and Central Bank 1993 (p. 94), 1992 (p. 163) (real wages); Handoussa 1991 (pp. 5–6); Richards 1991 (p. 1729); and Assaad 1991 (p. 140) (other labor market conditions). The dangers of relying on migration abroad as a solution to domestic labor market problems were vividly illustrated during the Gulf Crisis when some 400–700,000 Egyptians, most of whom were workers, returned in a few months’ time (see MEED, July 5, 1991; al-Hayat, December 17, 1991).

\(^4\) Along these lines, former Prime Minister Abdel Aziz Hijazi predicted that the revolutions of Eastern Europe would lead to the reallocation of a large part of Western aid away from the developing world \((\text{al-Ahram Weekly, September 5, 1991})\).
favorable view. As part of aid programs, thousands of Egyptians had studied, taken courses, or attended conferences in the United States and in Western Europe, while even larger numbers had benefited materially from aid. Moreover, advice embodying praise of the virtues of a capitalist strategy had been freely bestowed upon the Egyptian elite by innumerable foreign experts and researchers.

At the same time that the international and local ideological atmosphere changed, Egypt’s foreign donors and creditors, especially the IMF and the World Bank, strengthened their coordination and stiffened their negotiating positions, partly in reaction to their disappointment with Egypt’s failure to implement reforms promised in earlier agreements. Egypt’s precarious balance of payments situation enhanced the ability of the IMF and the World Bank to influence domestic economic policy. The IMF required Egypt to implement a large share of the program prior to the signing of the May 1991 standby agreement, including measures designed to reduce the budget deficit and liberalize the foreign exchange rate system (U. S. Embassy 1989; MEED, February 1, February 22, and June 7, 1991). The World Bank’s $300 million Structural Adjustment Loan, signed in November of 1991, hinged on the IMF agreement and was to be disbursed in two installments, the second of which depended on World Bank approval of reform measures, especially the privatization program (MEED, January 25, April 26, and July 5 1991; al-Hayat, November 24, 1991). The agreement with the IMF was also a preliminary requirement for the May agreement with the Paris Club on phased debt writeoffs, a 30 percent cut in interest rates on the debt, and the rescheduling of a portion of the remaining debt. Continued debt reductions were conditional on IMF approval of new reform measures (MEED, June 7 and 14, 1991). There were also signs that the Gulf countries would make IMF and World Bank approval a precondition for their future contributions.

Changes in Egypt’s position on both the international and Arab stages may also have encouraged orthodox reforms. As noted by Springborg, one consideration behind Egypt’s reluctance to fully embrace IMF advice in the late 1980s was its desire to maintain good relations with the Soviet Union and to avoid being seen as a U.S. pawn. This was especially important given Egypt’s vulnerable position as the only Arab country that had signed a peace treaty with Israel (Springborg 1989). Such considerations were less valid after the demise of the Soviet Union and the readiness of virtually all Arab governments to conclude peace agreements with Israel.

Domestic Politics: Reform by Stealth

Ultimately, policy changes require political decisions by policymakers who operate in the context of a domestic power balance. One important long-run trend generated by Egypt’s open-door policies was the growth of the private sector. By the end of the 1980s, it was clear that this sector had been able to translate its more significant role into

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5 The primary reason for the breakdown in the 1987 agreement with the IMF was the government’s failure to meet targets for budget deficit reduction (U.S. Embassy 1989).

6 This was in apparent contrast with the situation in 1987, when the United States, in a sudden turnaround, forced the IMF to accept a policy package the United States itself had considered inadequate a few months earlier (Sadowski 1987). David Carr, a USAID economist, asserts that donors in the late 1980s were becoming shrewder in their negotiating tactics with the Egyptian government.

7 It has been reported that the activities of the then declared (but never implemented) $10 billion Gulf Fund—the primary vehicle for Gulf state support to friendly governments—would be partly oriented by the IMF and the World Bank, and focused on direct support to the private sector in countries liberalizing their economies (Baker 1991; al-Hayat, February 5, 1992).

8 One indicator is the private sector share in industrial investment. In 1970–74, it was around 4 percent; in 1975–76 it had more than doubled to around 10 percent, while in the period 1987/88–1991/92, it had reached 49 percent (Central Bank 1992).
political influence. A comparison between Egypt's organizations for businessmen and its trade unions clearly shows that businessmen had emerged as a strong and unified force relatively independent of government influence since the late 1970s, while the trade unions were under considerable government control. Business also favored most, but not all, of the orthodox reform package, and its members were able to pressure government officials directly. The trade unions, in contrast, were opposed to most elements in the orthodox program, but they were divided. Their stance sometimes depended on whether they represented workers in the public or in the private sector. Since Egypt's General Confederation of Labor in the mid-1980s was regarded as a "veto group," this weakness may have been a necessary condition for the implementation of the orthodox reforms (Bianchi 1986; Qandil 1991).

While the government may have been subject to long-run pressures, it enjoyed particularly favorable conditions for the initiation of reform, or at least a fair degree of short-run independence. That this was the case may be ascertained by identifying the immediate losers and gainers from major economic policy changes associated with the reform program—the liberalization of interest and foreign exchange rates, the introduction of a sales tax, and the gradual reduction in the real wages of state employees.

The previous system of fixed interest and foreign exchange rates benefited those who had access to loans and foreign exchange at a discount—the public sector and privileged elements in the private sector. Liberalization in these areas hurt the groups most closely connected with the state machinery, and benefited the more removed portions of the private sector. Similarly, the introduction of the sales tax was to the immediate detriment of most of the population. Those who lost from the policy of gradually reducing the real incomes of the employees of the state were some 30 percent of Egypt's labor force. Neither the sales tax nor the reduction of civil service incomes had immediate beneficiaries. The gain may be a gradual improvement in macroeconomic performance—lower inflation, higher growth, and a lower foreign deficit. These policies, therefore, hurt groups that were closely connected with the state, an observation that supports the evidence of short-run government autonomy.

Such a conclusion can be explained by the findings of Grindle and Thomas (1991). On the basis of a large number of case studies of reform in the developing world, they found that governments in a state of perceived crisis enjoy a fair degree of short-run autonomy. They argue that, in crisis, the senior policymakers are more strongly involved in making the decisions and the government less likely to be the captive of micropolitical and bureaucratic concerns. Following their argument, to the extent that the Egyptian state (and its executive arm, the government) enjoyed a very short period of autonomy beginning in 1991 and its policy elite saw a crisis, effective resistance to reform was quite limited, at least for the first two years.

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9 For example, in the fall of 1991, government resistance to IMF pressure to impose higher taxes on its private sector was attributed to the political leverage wielded by business groups (al-Hayat, November 15, 1991). Awad argues that other government decisions may be explained by the influence of private business groups (1991).

10 Key examples of elements in the economic policies that Egypt's private sector oppose include the structure of import tariffs, the sales tax, credit ceilings, and high interest rates (al-Hayat, November 11, 1991; al-'Alam al-Yawm, December 5, 1991).

11 Along these lines, Hinnebusch (1993) argues that the failure of Egypt's government to pursue reforms in the 1980s was not because of lost autonomy, but reflected the absence of a national "project" guiding policy.

12 The same conclusion applies to the reduction of controls on imports and investments. The same group has gained from moves to close the gap between the interest rates charged private and public sector firms (see al-Ahram Weekly, September 12, 1991).

13 Similarly, Fitzgerald (quoted in Waterbury 1983, p. 14) has argued that state autonomy in the developing world is accentuated during periods of political and economic crisis (see Fitzgerald 1979, pp. 4–5).
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years. It was only in 1993 and 1994 that we begin to observe serious labor unrest (for example, Kafr el-Dawar textile industry).\textsuperscript{14}

Moreover, compared with the 1980s, the early 1990s suggest that government policy management had improved somewhat, at least in the fiscal area. The policymakers also perceived a quiescent population that would make serious political instability unlikely. Fear that reform would cause a repetition of the widespread food riots of January 1977 had been a major obstacle to reform, according to both the Egyptian government and analysts. The improvement in economic policy management was evident from the timing and the manner in which unpopular policy changes had been introduced. A key government practice has been referred to as “reform by stealth”: subsidies are maintained but the subsidized items themselves gradually disappear and are replaced by slightly modified and costlier items (Waterbury 1989). Another practice, exemplified by the introduction of price hikes and a general sales tax at the start of Eid al-Fitr (a religious holiday) in 1991, is to choose major holidays as the time to announce unpopular new policies, presumably on the assumption that people are less likely to take to the streets at such a time (\textit{MEED}, April 26, 1991).

The government has also struggled to make the new economic reforms more palatable by giving them a stamp of “Egyptianness”—although supported by the IMF, Egypt’s economic policies are presented as locally designed. One reflection of this was the announcement of a “1,000-day” program of economic liberalization in December 1990, some five months before the conclusion of the agreement with the IMF. Another indication is Mubarak’s insistence that, while the advice of the IMF is wise and welcome, the ideas behind the reforms are “purely Egyptian” (\textit{al-Ahram}, May 2, 1991).

This relatively skilled public relations management stands in sharp contrast to the manner in which the subsidy cuts of January 1977 were announced—as part of an agreement with a foreign agent, the IMF. Since then the government has been able to introduce more substantial subsidy cuts than those of January of 1977 without political instability. Along with Wahba, one may therefore conclude that the riots of 1977 should be viewed more as a reaction to the style with which the subsidy cuts were announced than to the cuts per se (Wahba 1989).\textsuperscript{15} It may also be argued that in the eleven interim years (1977–91), Egyptians have become less accustomed to governmental largess.”

Another consideration encouraging the introduction of the 1991 economic reforms was the absence in Parliament of the major opposition parties (the New Wafd and Labor-Islamic parties) and the weakness of the other parties, which suggested that there was no serious threat to political stability. Most other dissident groups apparently lacked the ability to mobilize a population that was unorganized and appeared “apathetic” (Youssif 1991; Springborg 1989).\textsuperscript{16} If disturbances had occurred,

\textsuperscript{14} Between September 27 and October 7, 1994, some 15,000 workers of the public sector of Misr Weaving and Textile Company went on a strike protesting new policies, measures, and regulations regarding layoffs, wages, and incentives. The unrest culminated in a violent confrontation between security forces and workers and their families on Sunday, October 2, 1994. According to opposition sources, three workers were killed and more than a hundred were wounded (\textit{al-Shaab}, October 4, 1994).

\textsuperscript{15} Youssif (1991) has properly noted that this raises a number of important questions for research: Which social groups are most strongly affected by the current economic reforms? What is their capacity to hinder or influence the reforms? The ultimate danger to the present order would arise if economic grievances were successfully utilized by an ideologically based organization able to mobilize the great mass of the population, such as the movement behind the Iranian Revolution (see Waterbury 1989).

\textsuperscript{16} The term “apathy” is used by Springborg (1989), Brumberg (1989), and Abdalla (1991) when describing the Egyptian public. This author does not agree with the above proposition in view of empirical evidence of several uprisings, riots, and incidents of politically motivated violence in the 1970s, 1980s, and early 1990s, as will be shown later.
the government was, and still is, much better equipped than it was in 1977 to handle them.17

The Timing of the Economic Policy Shift

The more precise timing of the policy shift was probably linked to the Gulf War. After its conclusion, an expected economic upturn and a relatively comfortable foreign exchange situation increased the political feasibility of the orthodox reform package. In general, feasibility increases for any reform package if conditions are not immediately perceived as getting worse after the reform begins. Orthodox reform programs are at a disadvantage because they tend to shrink economic activity, at least in the short run. During the Gulf Crisis, the producing sectors and the general public (as opposed to the government) went through some bad times because of a decline in foreign exchange earnings from tourism and worker remittances, higher transportation costs for international trade, and an uncertain economic climate. Other things being equal, a general upturn would have been expected in the aftermath of the war as conditions went back to normal, including the return of tourists to Egypt and Egyptian workers to the Gulf.18

During the Gulf War contributions received from Western and Arab governments doubled official foreign exchange reserves (MEED, May 3, 1991). In the same period, Egypt was forgiven debts to the United States and Arab Gulf countries amounting to some $14 billion. After the agreement with the IMF, the Paris Club decided to cut Egypt’s foreign debt gradually by another $10 billion, and to reschedule and cut interest rates on $10 billion of the remaining debt.19 In addition, Egypt’s major donors promised increased foreign aid over the next few years (while doubts prevailed regarding the longer run). Together this meant that Egypt’s debt service burden had diminished significantly and that the country’s future foreign exchange situation was quite comfortable, making it possible to avoid rapid devaluation of the Egyptian pound while permitting it to float in a relatively unregulated market (Shihata 1993; Amin 1994). Nominal exchange rate stability has the benefits of stabilizing the economy, increasing Egypt’s creditworthiness, reducing capital flight, and limiting inflationary pressures from cost increases for imported goods. But as noted later in this chapter, the pursuit of nominal exchange rate stability may be highly questionable for a country with higher inflation than its major trading partners.

These factors—a stable currency and the multiplier effects of increasing foreign exchange earnings from tourism and migrant workers—were not a result of the government’s policy shift. Their combined impact was nevertheless to make the new policies more palatable to the Egyptian public than would otherwise have been the case. Nevertheless, the same considerations would also have made it easier to continue for some time without any reforms—there is no urgent need to change anything when the economy is improving and plenty of foreign exchange is available. Thus, while these two factors may be necessary conditions for a change in economic policy, they are by no means sufficient and should be viewed in the context of the international and domestic conditions discussed earlier.

17 This is most clearly manifested by the emergency laws (in effect since Sadat’s assassination in 1981), extended for another three years in May 1991. When commenting on the 1991 extension, Interior Minister Moussa linked it directly to the economy, saying that they were needed “to secure our internal front, and this is vital for economic reform” (MEED, June 7, 1991). Ayoubi (1982) notes that government preparations in this area were upgraded after the 1977 riots. The quick response to the Kafr al-Dawar labor unrest (see footnote 14) lends support to this observation.

18 Accordingly, at the time of the reforms and in spite of their implementation, the expected real GDP growth rates for 1991 and 1992 were not very different from those of the late 1980s (EIU Country Report 3, 1991).

19 Thus, after the debt cuts from the United States and the Gulf states, the foreign debt had fallen to $35 billion (MEED, February 15, 1991). Assuming that the Paris Club cuts are implemented in full, Egypt’s foreign debt in mid-1991 was around $25 billion.
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The Economy Since 1991: Policies and Trends

This section provides a more detailed account of the reform program and its effects. The discussion covers stabilization policy and performance, structural adjustment policies, problem areas, and prospects for future economic policy.

Stabilization Policy and Performance

Some indicators of recent trends in stabilization policy and their effects are shown in table 1. A major shift in this area is a substantial reduction in the government budget deficit. According to Central Bank data, it fell from 15 percent of GDP in the most recent prereform years to roughly 4 percent in 1991/92 and 1992/93.20 This drop is the product of both spending cuts (the steady reduction of subsidies to energy and selected food products) and revenue-boosting measures (Shihata 1993). In the latter area, the 1991 introduction of a general sales tax is a major contributor. The previous "consumption tax" accounted for LE 3.4 billion in 1990/91. Increased and renamed a "sales tax," it more than doubled two years later (1992/93) to LE 7.4 billion. All tax revenues grew from LE 7.8 billion to 13.3 billion in the same period (an increase of 71 percent). In spending, the state reduced its subsidies to goods and services from LE 4.5 billion to 3.8 billion (16 percent) in the one year immediately following the beginning of ERSAP. As a result of canceling some of its external debt in 1991, the debt service decreased from LE 5.0 billion to LE 4.6 billion between 1991 and 1992. Public investment has not suffered as a result. On the contrary, it showed a steady increase in the two years following the implementation of ERSAP.

The money supply growth rate (according to the narrow M1 measure) is slightly downward, reflecting, in part, that since 1991 the government budget deficit has been financed primarily by weekly treasury bill auctions, a clear break from past reliance on borrowing from the Central Bank.

Table 1
Indicators of Recent Stabilization Policy and Performance

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</tr>
</thead>
<tbody>
<tr>
<td>Government spendinga</td>
<td>43.6</td>
<td>43.5</td>
<td>37.9</td>
<td>40.9</td>
<td>34.2</td>
<td>33.9</td>
</tr>
<tr>
<td>Government revenuea</td>
<td>25.9</td>
<td>27.7</td>
<td>22.8</td>
<td>25.7</td>
<td>29.8</td>
<td>30.4</td>
</tr>
<tr>
<td>Budget deficit (as percent of GDP)</td>
<td>17.6</td>
<td>15.8</td>
<td>15.1</td>
<td>15.2</td>
<td>4.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Money supply (M1) (percent growth/yr)</td>
<td>12.8</td>
<td>9.2</td>
<td>16.6</td>
<td>8.1</td>
<td>8.8</td>
<td>12.1</td>
</tr>
<tr>
<td>Inflation (percent/yr, CPI)</td>
<td>17.6</td>
<td>21.3</td>
<td>16.8</td>
<td>19.8</td>
<td>15.0</td>
<td>12.5</td>
</tr>
<tr>
<td>Real GDP (percent growth/yr)+</td>
<td>3.9</td>
<td>3.0</td>
<td>2.6</td>
<td>2.3</td>
<td>2.8</td>
<td>n.a.</td>
</tr>
<tr>
<td>Earlier estimates</td>
<td>5.4</td>
<td>5.0</td>
<td>5.7</td>
<td>1.1</td>
<td>4.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Revised estimates</td>
<td>-544</td>
<td>-469</td>
<td>-634</td>
<td>1,373</td>
<td>3,737</td>
<td>4,774</td>
</tr>
<tr>
<td>Current account surplusa ($mill)</td>
<td>-544</td>
<td>-469</td>
<td>-634</td>
<td>1,373</td>
<td>3,737</td>
<td>4,774</td>
</tr>
</tbody>
</table>


19 According to IMF data and definitions, the deficits were 6.4 percent and 4.7 percent of GDP in 1991/92 and 1992/93, respectively (EIU Country Profile 1993). For 1993/94, the IMF target is 2.6 percent (EIU Country Report 1, 1994).
Governance, Leadership, and Communication: Building Constituencies for Economic Reform

Bank (Central Bank 1992). While interest rates were previously permitted to fluctuate within narrow limits, in 1991 banks were given the freedom to set virtually all deposit and lending rates. In practice, the interest rates on treasury bills have provided an anchor for bank interest rates. As a result, interest rates on bank deposits are close to or slightly above the inflation rate (MEED, January 18 and May 24, 1991; U.S. Embassy 1991; EIU Country Profile 1993/94).

Policies related to the foreign exchange rate have also changed. In February of 1991, the government merged the multiple rates of the earlier policy regime to a single rate and depreciated the Egyptian pound by 10 percent against the U.S. dollar (MEED, March 15, 1991). The capital account was also liberalized (that is, most restrictions on access and transfers abroad were removed for dollars and other currencies), putting an end to a flourishing black market (EIU Country Report 3/1992; Giugale 1992). Since then, government exchange rate policy has aimed at maintaining a stable nominal Egyptian pound rate in relation to the dollar, a goal achieved through Central Bank interventions in the currency market (EIU Country Report 4/1992).

Lower budget deficits and money supply growth, higher interest rates, and the shift from gradual depreciation to a fixed nominal exchange rate have brought about a lower rate of inflation. Data on annual real GDP growth are very uncertain, as illustrated by the display of two alternative series in table 1. Both series show positive growth, averaging 2.3 percent in the early 1990s. Nevertheless, uncertainty about the growth rate is compounded by the strong presence of an informal sector, which lacks a precise record of size and growth rate. The standard assessment is that its size corresponds to 25–50 percent of GDP (U.S. Embassy 1994; EIU Country Profile 1993/94). Recent acts of Islamist violence, primarily aimed at government officials, tourists, and Copts, have deprived the economy of foreign exchange earnings from tourism and worsened the investment climate.

For the first time in decades, Egypt has positive real interest rates. A combination of liberalized capital flows, nominal interest rates far above international levels, and the expectation of a stable nominal exchange rate led to a much higher real return from placing funds in Egyptian pounds compared with dollars or other major currencies. The result was a strong incentive for workers abroad to remit current earnings back home (Shihata 1993). Together with the exceptional circumstances during the 1990–91 Gulf Crisis (high oil prices and large transfers to the government), this has led to a positive net on the current account of the balance of payments in 1990/91–1992/93, as illustrated in table 2. Additional inflows on the capital account were also encouraged, leading to large short-term capital inflows. Taken together, these developments have generated a large increase in Egypt's foreign currency reserves, from $2.7 billion in 1990 to an unprecedented $17 billion in the second half of 1993 (EIU Country Profile 1993/94).

21 In preceding years, when official rates overvalued the Egyptian pound, there was excess demand and (nonprice) rationing of dollars, giving rise to a large black market. Among the rationales for capital account liberalization are encouragement of foreign direct investments and discouragement of capital flight.

22 These are not the only alternatives. As an example, according to the World Bank (1993), the real GDP growth rates were 2.5 percent (1989/90), 2.3 percent (1990/91), and 0.3 percent (1991/92). The EIU estimate for 1992/93 is 0.5 percent (EIU Country Report 1/1994).

23 For example, if the investor kept her funds in U.S. dollars, they would grow at a rate of 3 percent yearly; if shifted into Egyptian pounds for one year and subsequently transferred back into dollars (at a fixed nominal exchange rate), the growth rate would be 15 percent (ignoring transaction costs), in 1992/93.
### Table 2
**Desegregated Current Account Data**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil</td>
<td>1,066</td>
<td>87</td>
<td>1,229</td>
<td>100</td>
<td>1,971</td>
</tr>
<tr>
<td>Other goods</td>
<td>1,631</td>
<td>85</td>
<td>1,916</td>
<td>100</td>
<td>1,916</td>
</tr>
<tr>
<td>Suez</td>
<td>1,307</td>
<td>89</td>
<td>1,472</td>
<td>100</td>
<td>1,662</td>
</tr>
<tr>
<td>Tourism</td>
<td>901</td>
<td>84</td>
<td>1,072</td>
<td>100</td>
<td>931</td>
</tr>
<tr>
<td>Other services</td>
<td>5,046</td>
<td>95</td>
<td>4,239</td>
<td>100</td>
<td>5,093</td>
</tr>
<tr>
<td><strong>Transfers</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government</td>
<td>711</td>
<td>65</td>
<td>1,094</td>
<td>100</td>
<td>1,487</td>
</tr>
<tr>
<td>Private</td>
<td>3,532</td>
<td>94</td>
<td>3,743</td>
<td>100</td>
<td>3,751</td>
</tr>
<tr>
<td>Total</td>
<td>13,194</td>
<td>89</td>
<td>14,764</td>
<td>100</td>
<td>16,810</td>
</tr>
<tr>
<td><strong>Spending</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Imports</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods</td>
<td>10,361</td>
<td>91</td>
<td>11,441</td>
<td>100</td>
<td>11,425</td>
</tr>
<tr>
<td>Services</td>
<td>3,302</td>
<td>83</td>
<td>3,957</td>
<td>100</td>
<td>4,012</td>
</tr>
<tr>
<td>Total</td>
<td>13,662</td>
<td>89</td>
<td>15,398</td>
<td>100</td>
<td>15,437</td>
</tr>
<tr>
<td><strong>Balances</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goods</td>
<td>-7,664</td>
<td>92</td>
<td>-8,296</td>
<td>100</td>
<td>-7,538</td>
</tr>
<tr>
<td>Services</td>
<td>2,952</td>
<td>104</td>
<td>2,826</td>
<td>100</td>
<td>3,673</td>
</tr>
<tr>
<td>Transfers</td>
<td>4,243</td>
<td>88</td>
<td>4,836</td>
<td>100</td>
<td>5,238</td>
</tr>
<tr>
<td>Current account</td>
<td>-469</td>
<td></td>
<td>-634</td>
<td></td>
<td>1,373</td>
</tr>
</tbody>
</table>

**Note:** Data are for fiscal years (1989 = 1988/89, and so forth).

**Sources:** Central Bank Annual Report, various years.

### Structural Change

In the area of structural change, the shift in policy direction has targeted pricing policy, foreign trade, public sector reform, privatization, and the conditions for private sector activities. In the reform program, the overall purpose is to get closer to a competitive market economy where producers and consumers face prices that approximate the opportunity costs for traded goods based on the international price level (Shihata 1993).

**Administrative Price Controls**

Since the beginning of the reforms, Egypt has witnessed significant changes in price and foreign trade policy. Among the goods with administrative price controls are petroleum products, which were raised from 35 percent to 80 percent of the international level between 1990 and the end of 1992, and electricity, which increased from 22 percent to 69 percent of the long-run marginal cost (that is, the marginal cost of additional production capacity) (Richards 1991; U.S. Embassy 1993). For the industrial sector, all prices except those of pharmaceuticals and a few other goods have been decontrolled (U.S. Embassy 1993). Subsidies on controlled food prices were reduced substantially in 1991 and 1992, although the socially and politically important bread subsidy remains largely intact (EIU Country Profile 1992/93; MEED, July 10, 1992). In the agricultural sector, subsidies for most inputs were terminated (EIU Country Report 2/1993). Between 1990 and 1992, cotton prices rose from 50 percent to 66 percent of the international level, and in 1993 the price was above the international level for some varieties (EIU Country Profile 1993/94; U.S. Embassy 1994).
Foreign Trade

Table 3 shows that nontariff and tariff barriers to foreign trade have been reduced significantly. Other things being equal, this means that new export opportunities have been opened up and local production has become more exposed to competition from imports.

Public Enterprise Reform

In 1991 a reorganization of the public sector was initiated. More than 300 public companies are now subsidiaries under independent holding companies, which have replaced the general organizations that controlled state enterprises along the lines of government ministries. In principle, the companies are to be run along commercial lines, competing on equal terms with the private sector. Companies may be leased or sold to the private sector (MEED, June 28, and August 23, 1991, March 12, 1993; U.S. Embassy 1992; EIU Country Report 4/1992).24 The impact of the reform on the management of public sector companies is not yet clear. This is also the case for the privatization process—completed sales of public sector companies have so far been limited to a few hotels, land assets, two bottling plants, and small projects owned by the governorates (MEED, March 12, 1993; al-Hayat, January 4, 1993; U.S. Embassy 1994). A small percentage of the share capital of a large number of public companies has also been sold.

The privatization issue is highly controversial. There are fears that, given the absence of clear limits on sales to foreigners, national independence will suffer. The notion that the private sector is more efficient than the public sector is also contested (Abdel-Khalek 1992). Moreover, the determination of what constitutes the “true” value of the companies is hotly disputed (Badawi 1993; Maraghi 1993). Other factors that have limited the extent of privatization thus far are concerns that it will generate higher unemployment and the negative impact of the downturn in tourism on the value of some of the most attractive assets. In addition to government hesitation, another factor that has slowed privatization is the complicated and time-consuming bidding procedure. Outside pressures to privatize have been reduced by Egypt’s current agreement with the World Bank, which stipulates that the government is not obliged to sell any assets if the offer is considered unfair, after objective evaluation (EIU Country Report 1/1994).

It seems, nevertheless, that conditions for the private sector have improved. One indicator is stronger guarantees for investors and less complicated investment approval procedures. In 1991, legal automatic approvals were issued for investments in all areas except those included on a “negative” list, which is being shortened (U.S. Embassy 1991; MEED, June 7 and 21, 1991; EIU Country Profile 1992/93; EIU Country Report 1/1994). In agriculture, controls on the cropping pattern have been lifted step-by-step; in 1993, they were limited to cotton and sugarcane (EIU Country Profile 1992/93).

Problems and Future Prospects

Policy Dilemmas in International Trade and Finance

Significant success in both stabilization and structural adjustment notwithstanding, major short- and medium-run problems are found in the area of foreign trade and exchange rate management. The aim of reducing Egypt’s chronic deficit in goods trade has not been fulfilled (see table 2), depriving the domestic economy of an important potential source of demand stimulation during a period of contractionary policies.25 Any reduction in the goods trade deficit is made difficult by recent exchange rate appreciation. Although Egypt’s infla-

24 Close to fifty state-owned companies active in the following areas will be unaffected by the law: military production, oil, banks, iron and steel, aluminum, and the Suez Canal (MEED, June 28, 1991).
25 This concern has been expressed by the IMF (EIU Country Report 4, 1992).
Successful Adjustment and Declining Governance? The Case of Egypt

Table 3
Recent Changes in Foreign Trade Policies

<table>
<thead>
<tr>
<th>Policy</th>
<th>Prereform (1990/91)</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export bans</td>
<td>20 goods</td>
<td>2 goods</td>
</tr>
<tr>
<td>Export permits</td>
<td>37 goods</td>
<td>abolished</td>
</tr>
<tr>
<td>Import bans</td>
<td>111 goods</td>
<td>26 goods</td>
</tr>
<tr>
<td>Standard minimum and maximum tariffs</td>
<td>1–240%</td>
<td>10–70%</td>
</tr>
</tbody>
</table>


...tion has been higher than that of its main trading partners, the Egyptian pound has remained relatively stable in nominal terms in relation to the currencies of these countries.26 This combination of circumstances undermines the competitiveness of Egypt's production of tradables (exports and import substitutes).27 Accordingly, domestic producers find it increasingly difficult to face foreign competition (al-Ahram Weekly, February 4 and April 8–14, 1993). The continuation of this exchange rate policy may undermine the political viability of import liberalization. One may fear that the industries most successful in securing protection from foreign competition are those with the most political clout, not those with the strongest economic rationale for protection—for example, a strong future export potential.

This arrangement cannot continue for long. Sooner or later expectations of a nominal depreciation will build up (unless trade liberalization is discontinued), encouraging capital flight, turning depreciation into a self-fulfilling prophecy, and causing a severe blow to the buildup of confidence in the Egyptian pound.28 The result—real exchange rate instability without much impact on the long-run level of the nominal exchange rate—is likely to reduce long-run growth (Corden 1991). To minimize the risk of instability, it is essential to cut inflation further, encourage exports, and, at an appropriate time, devalue the currency to restore competitiveness. After these steps have been taken, the experience of many countries speaks in favor of a shift to a policy of maintaining a stable real exchange rate through frequent changes in the nominal rate to account for inflation differentials, perhaps by a crawling peg arrangement (da Silva Lopes 1989; Dornbusch 1991; Edwards 1992).29

The Distributional Impact of Reforms

With a GNP per capita of about $600–700, Egypt is a border case; it falls between the low- and lower-middle-income countries, as determined by the World Bank classification. According to UNDP’s broader Human Development Indicator, Egypt in 1993 was ranked 124 out of 173 countries on the basis of data for 1990 (INP 1994).30 Some 20–25 percent of the population may live on a total monthly income below a poverty line

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26 According to the World Bank (1993a), the Egyptian pound appreciated in real effective terms by 25 percent between 1991 and 1993. That nonoil exports have been stagnant since 1989/90 may be an indicator that the exchange rate is overvalued (see floor discussion of Corden’s paper, Corden 1991).

27 da Silva Lopes (1989) suggests that reduced protection against imports be accompanied by depreciation—since the devaluation in February of 1991, Egypt has done the opposite. Handoussa (1990) strongly emphasizes that Egypt’s manufactured exports are highly sensitive to the real exchange rate and that poor export performance in the 1980s was partly the result of an overvalued exchange rate. It is, however, striking that the debate in the Egyptian press is focused on tariff changes and the removal of import bans, not on the very crucial issue of the appreciating real exchange rate.

28 In this context, it is important to emphasize that the large capital inflows of recent years were attracted by a higher expected return from investment in Egyptian pounds compared with other currencies. These inflows may turn into outflows at short notice if the expected return on pounds declines—for example, because of an expected devaluation. This danger is intensified whenever Egypt’s foreign exchange earnings decline for exogenous and noneconomic reasons, such as the recent weak oil market and a fall in tourism revenues.

29 For a crawling peg, the rate of depreciation would approximately equal the difference between the rates of inflation in the country in question and its major trading partners.

30 UNDP’s Human Development Indicator is a composite measure based on life expectancy at birth, adult literacy rate, and real per capita GDP adjusted for the purchasing power ratio (INP 1994).
Table 4  
Indicators of Social Impact of Reforms

<table>
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</thead>
<tbody>
<tr>
<td>Wages (percent of GDP)</td>
<td>36.8</td>
<td>35.5</td>
<td>32.8</td>
<td>26.1</td>
<td>27.0</td>
</tr>
<tr>
<td>Real wage (91/92 LE)</td>
<td>2,973</td>
<td>2,741</td>
<td>2,678</td>
<td>2,513</td>
<td>2,586</td>
</tr>
<tr>
<td>Subsidies (percent of GDP)</td>
<td>3.4</td>
<td>4.3</td>
<td>5.0</td>
<td>5.2</td>
<td>2.6</td>
</tr>
</tbody>
</table>

Note: Data are for fiscal years (1989 = 1988/89, and so forth). The wage share is the share of GDP at factor cost paid to labor, using current LE data except for 1992/93, for which 1991/92 LE data were used. The real wage is computed as total employment divided by total labor income, adjusted for changes in urban CPI. In 1991/92, the exchange rate was LE3.33 per U.S. dollar. Sources: CAPMAS 1993; World Bank 1993; Central Bank 1992/93, 1991/92.

Table 5  
Indicators of the Prospects for Long-Run Growth

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</thead>
<tbody>
<tr>
<td>Government spending on health &amp; education</td>
<td>5.0</td>
<td>n.a.</td>
<td>6.2</td>
<td>5.7</td>
<td>6.1</td>
</tr>
<tr>
<td>GFC Earlier estimates</td>
<td>28.1</td>
<td>26.0</td>
<td>22.3</td>
<td>17.9</td>
<td>n.a.</td>
</tr>
<tr>
<td>Revised estimates</td>
<td>30.1</td>
<td>27.6</td>
<td>25.0</td>
<td>20.6</td>
<td>18.2</td>
</tr>
</tbody>
</table>

n.a. Not available.

Note: Data are for fiscal years (1989 = 1988/89, and so forth). GFC = Gross Fixed Capital Formation. Information is computed on the basis of current LE data except for 1992/93 GFCF, which is based on 1991/92 LE. Current GDP at market prices for 1992/93 (used for health and education data) is based on an EIU estimate.


of $350 (EIU Country Profile 1993/94). The information suggests that the size distribution of income is relatively equitable (compared with other developing countries) and stable over time; in the 1980s it may have deteriorated slightly (INP 1994). In the absence of direct data on poverty and income distribution, the social impact of reforms will be examined through indirect indicators, displayed in Table 4.

The share of GDP at factor cost accruing to labor (with the remainder represented by rents for capital and land) is positively related to income equality on the reasonable assumption that labor income is more evenly distributed than other factor incomes.\(^3\) Also, if labor income represents a predominant share of the incomes of poor groups, changes in real wages should be positively related to poverty elimination. Table 4 shows that the share of wages in GDP declined in 1989–92, with a significant drop between 1991 and 1992. Real wages were also declining, but no significant drop is observed for the reform period. The marginal increase in both indicators in 1993 fails to compensate for the losses of the previous years. Finally, subsidies, which increased as a percentage of GDP until 1992, declined sharply in 1993.\(^3\)

Given that subsidized goods, primarily foodstuffs, represent a relatively large share of the expenditures of low-income households, these cuts have had a negative effect on the real incomes of these households, both in absolute terms and in relation to better-off groups. Data limitations notwithstanding...

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31 Amin asserts that "most wage earners, taken as a whole, belong to the lower- or middle-income groups" and that "income equality is thus positively related to the share of wages in GDP" (1987, p. 101). Similarly, the Institute of National Planning points to higher rents relative to wage income as a source of inequality (INP 1994).

32 The same conclusion also holds if government subsidies are measured in real LE or real LE per capita. The subsidy figures reflect budgetary outlays that are only approximate indicators of actual subsidy value due to bank borrowing and repayments by the subsidizing agency. The trend is also the same if, alternatively, the subsidies are measured by budgetary authorizations (EIU Country Profile 1993/94).
Successful Adjustment and Declining Governance? The Case of Egypt

ing, it seems safe to conclude that the overall short-term effect of reforms on income equality, and on the incomes of more vulnerable groups, has been negative.

**Missing Prerequisites for Long-Run Growth**

It is widely agreed that a highly skilled labor force is a prerequisite for rapid and broad-based growth (Amin 1987; Shapiro and Taylor 1990; Fischer and Thomas 1990). As previously noted, in 1993 Egypt ranked 124 out of 173 countries according to UNDP's Human Development Index, a ranking that the Institute of National Planning considers "both unsatisfactory and indicative of a faltering human development status" (INP 1994, p. 13). The GDP share for government spending on education and health is commonly used as a proxy for the relative emphasis on investment in human capital. Data presented by the INP suggest that, between 1986/87 and 1991/92, this share fell from 5.7 percent to 5.2 percent (INP 1994). Although the numbers are slightly different in table 5, it is clear that current government investments in human development are insufficient to bring about any significant qualitative improvement. Moreover, there is reason to fear that the nutritional and health standards of Egypt's poorest groups suffer as a result of general subsidy cuts in the absence of income growth or a social security network for the neediest.

Along with investments in Egypt's human resources, high levels of efficient physical investments are essential for rapid growth. As shown in table 5, the GDP share for gross fixed capital formation (that is, investment in physical capital) declined between 1988/89 and 1991/92, according to both earlier and revised estimates, a trend that continued in 1992/93. One consequence of increased reliance on markets and the private sector is that the government has relinquished some of its control over investment levels—a strong upsurge in business investment requires, and would reinforce, growth and optimism about the future.

**Credibility Issues**

The credibility of the government in carrying out a program depends on its perceived commitment and ability to implement it. Given the emphasis on the private sector in the Egyptian program, credibility is particularly necessary to convince this sector to embark on virtually irreversible capital investments in activities that would be profitable in a more liberal environment. If in doubt about future policies, private investors have the option of keeping their capital in liquid form, thereby adding to economic stagnation. If they conclude that liberalization will be discontinued, they may invest in activities that are profitable under restrictive current policies, thereby reducing the gains from, and adding to the resistance to, future liberalization (Cooper 1991; Dornbusch 1991; Fischer and Thomas 1990).

Credibility was boosted by the prompt initiation of a series of measures in 1991, as well as continued cuts in the budget deficit. The conditional support for the reforms from the IMF and the World Bank, with associated carrots and sticks, added to this boost (Dornbusch 1991; Cooper 1991). Nevertheless, it soon became clear that the Egyptian government had opted for a very gradual—and slow—implementation of the reform program. From the perspective of credibility, gradualism is a double-edged sword, particularly if it is unconvincing as a strategy, but instead is perceived as ambivalence. On the positive side, a gradual reform program has a better chance of short-run political survival; it is easier to monitor the effects, and respond. In addition, there is more time for labor to move between sectors in response to liberalization measures, which minimizes transitional unemployment and related negative political repercussions. At the same time, if change is introduced very slowly and with great hesitation, credibility may suffer as doubts arise that the government ever intends to implement the program (Bruno 1988). Unfortunately, this pattern can be recognized in Egypt: hesitant imple-
mentation of trade liberalization, public sector reform, and privatization have been the subject of continuous complaints from economists as well as the World Bank and the IMF (MEED, March 5 and May 28, 1993; EIU 2/1993; al-Hayat, February 27, 1993). Moreover, one gets the impression that some important reform measures have been implemented primarily in response to pressures from the IMF and the World Bank; this creates doubts about whether the reforms would continue in the absence of such pressure.

Future Policies

At the time this chapter is being written, October 1994, it seems that government economic policy over the next few years will be an extension of the policy shift pursued since 1991, although it will proceed at an even slower pace. Government budget and monetary policies will remain tight, assisted by increased revenues as energy prices get closer to their international equivalents.

In response to political instability, the government budget will probably emphasize security and social programs, including services and infrastructure for low-income areas. Trade liberalization and privatization will proceed in a gradual fashion, accompanied by a marginal depreciation of the Egyptian pound. It seems that most of the remaining subsidies (primarily on bread and cooking oil) will be retained. A new labor law is expected to follow that will give employers more freedom to hire and fire. Policies along these lines were codified in a new three-year agreement with the IMF in September 1993, and in an agreement with the World Bank on a Structural Adjustment Monitoring Program in the same month. The IMF was to determine in June 1994 whether Egypt, up to that point, had implemented the program in order to effect a third and final cut in the debt of $4 billion (EIU Country Report 4/1993), but the IMF recommendation was postponed for later in the year. There seems to be a difference between the IMF and the World Bank in the assessment of Egypt's progress in implementing the reform package.

The pace of change, however, is expected to slow further for two primary reasons. First, as a result of domestic political instability the government will become more cautious. Second, the structural reforms that have not yet been implemented or completed—privatization and trade liberalization—are politically more difficult. It thus

33 Slowness has also been the hallmark of the Social Fund for Development, which is intended to facilitate structural adjustment by supporting small, labor-intensive projects and public works, among other programs. In its first year, it did not implement or support a single project. It has become more active recently; by January 1994, it had disbursed $97 million out of $613 million in donor pledges, creating a claimed 93,000 jobs (some of which are temporary) (al-Hayat, December 10, 1992; U.S. Embassy 1992, 1994). Nevertheless, the limited size of the fund and the absence of an effective social security network add to government hesitation about reforms that have short-run negative social effects.

34 In 1991, the budget deficit reduction and the foreign exchange reform were preconditions for the IMF agreement (MEED, February 1, 22, and June 7, 1991; U.S. Embassy 1991). Energy prices were raised in the summer of 1992 after an IMF decision to suspend the second review of its agreement for three months (MEED, July 10, 1992). In March 1993, trade liberalization and steps toward privatization led to the release of the second tranche of the World Bank Structural Adjustment Loan (MEED, March 12, 1993). Along these lines, the former Minister of Planning, Muhammed al-Imam, has stated that "reform, until now, has taken place willingly and under some kind of pressure and without a clear view" (al-Ahran, August 13, 1993).


36 In December 1993 a new unified income tax law was passed by the Parliament. According to this law, taxes are divided into three categories—salary tax, movable capital tax, and a unified tax (on commercial and industrial profits and noncommercial income). The effect on revenue is unclear; while many rates are lowered, tax evasion may also be reduced (EIU Country Report 1/1994; U.S. Embassy 1994).

37 As an indicator of this slowdown, the government in early June 1994 announced its postponement of the two future stages of broadening the sales tax to the wholesale sector, and later to a full value added tax (al-Ahran, June 2, 1994; EIU Country Report 1/1994).
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can be expected that, compared with what has already been achieved in the reform agenda, the remaining components of policy reform will present stronger challenges to both the political and technical capacity of the government. Moreover, after the expected third and final round of debt cuts later in 1994, the leverage of the IMF and the World Bank over Egypt’s economic policies will be reduced, which should add to the slowdown.

Governance Capacity and Egypt’s ERSAP

In this section we look at governance capacity—for which “vision” is often the moral and spiritual locomotive. One of the main hypotheses of this research project predicates the success of ERSAP on an accompanying effective “vision” advanced by the ruling elite (Atiyas and Frischtak 1993). A “vision” is defined as the political articulation of national objectives or a national project, inspiring and mobilizing large segments of the public behind a set of policies derived from the vision or perceived to be instrumental in attaining it. It is normal that a vision and its concomitant policies promise greater, but somewhat delayed, new gratification than that previously promised by an older one. In this sense a vision may be thought of as a promissory note of later compensators for immediate sacrifices.

When President Mubarak came to power, Egyptians’ collective memory already had been tuned to two, though quite different, visions—Nasser’s and Sadat’s. Egyptians had initially received both visions with enthusiasm, but were profoundly disappointed toward the end. The payoff was either too small or outright negative for most Egyptians. Mubarak was cognizant of the fate of his predecessors and their respective visions. On several occasions during his first term in office (1981–87), Mubarak made known his aversion to ideologies, slogans, big words, and what he once called “sales of dreams which often turn into illusions and disappointments.”

He had to be frank and to level with his people (Mubarak, May 1, 1982).

Mubarak’s Reluctant Search for a Vision

Despite his noted aversion to vision-making, Mubarak could not altogether avoid it. Whatever Mubarak could achieve politically would be de facto hailed as if it were a part of a “vision.” The efforts, however, were asystematic, not consistently backed by policy initiatives, and never added up to a comprehensive and clear message. In his first year in office, the emphasis was on the “cleansed or purified society” (Mugtam’a attahara, Mubarak, July 23, 1982). This was an obvious reference to combating corruption, which was said to be rampant in the last years of President Sadat. The regime investigated and brought to trial several public and semi-public figures on charges of corruption, including the brother of his predecessor (Ismat Sadat).

Also among Mubarak’s early slogans were “production,” “productivity,” “combating waste,” and correcting the “excesses” of the Open-Door Economic Policy (ODEP or Infitah) (Mubarak 1982, October 6). It was clear that the economy was an obsession with the new president. He saw in its streamlining and invigoration, “the key to all of Egypt’s other problems” (Mubarak’s speech to the Economic Conference, February 22, 1982). While he remained cautious in effecting any major policy change, however, he continued to ex-

38 In an audience with the author on April 19, 1982, President Mubarak poked fun at those who try to persuade him to adopt a “national project” (Mashrou’a Qawmy).
hort Egyptians to “produce more and consume less for the sake of Egypt” (Mubarak, May 1, 1983). Toward the end of his first term (1986), Mubarak saw Egyptian revenues, from both oil and remittances, decline sharply. Despite changing his prime minister and the cabinet members responsible for the economy at least three times, Egypt’s economy did not show marked signs of improvement. Nevertheless, the Mubarak regime continued to borrow from abroad and to resist the ERSAP suggested by the IMF and the World Bank. Regionally and domestically, the regime was doing fairly well. Egypt was steadily normalizing its relations with the rest of the Arab World, thanks to the Iraq-Iran War, which made the Arab Gulf countries appreciate Egypt’s strategic assets more than ever. Some one million Egyptians were working in Iraq, and Egypt was exporting some $1.0 billion worth of weapons and ammunition annually to Iraq (ASR 1987). Domestically, public opinion (including major opposition parties) continued to lend general support to President Mubarak, hailing his integrity, despite expressed misgivings about some governmental policies and cabinet members (ASR 1986). These achievements seemed to reinforce Mubarak’s cautious orientation and his aversion to developing an overall “political vision.”

With his second term (1987–93), President Mubarak began to use overarching slogans in his political discourse—for example, the need and call for a “National Awakening” (al-Sahwah) and the “Big National Renaissance” (al-Nahdah). With the economy still dominating his discourse, Mubarak began to call for curbing population growth, reforming education, and emphasizing science and technology as imperatives for entering the twenty-first century (May 1, 1987; October 6, 1988; July 23, 1989). Completing the full rehabilitation of Egypt in the Arab World (1989), Mubarak added to his public discourse “regional peace and cooperation” as integral parts of Egypt’s strategy for the future (ASR 1989, pp. 558–69). These regional dimensions of a budding vision coincided with the formation in 1989 of the Arab Cooperation Council (ACC) comprising Egypt, Iraq, Jordan, and Yemen. The emphasis on Arab links bore some resemblance to that of Nasser’s vision, but without the militant ideological edge. At the time it seemed to promise an Arab Common Market that would give Egypt a vital economic sphere—that is, direct aid and outlets for its surplus labor, bringing greater remittances. This fledgling vision and the hopes it raised were short-lived, however, and ended with the Gulf Crisis (1990–91) following Iraq’s invasion of Kuwait. Egypt opposed its three partners in the ACC (Iraq, Jordan, and Yemen) and sided with the Gulf Arab countries and the Western-led International Coalition (Mubarak, December 15, 1990).

In 1991 Mubarak’s public discourse reasserted the value of his earlier caution in enacting measures of gradual political and economic change at home. In a self-congratulatory tone, Egypt’s orderly change was contrasted with the disorderly change in Algeria and the Soviet Union. Egypt’s leadership in regional affairs and its stature in international forums were highlighted by Mubarak and the state media (Mubarak, March 3, 1991). The promise of additional foreign aid and cancellation of some external debts, during and shortly after the Gulf Crisis, were presented as a reward and vindication of Egypt’s leadership and sound policies. That being the case, Egypt could confidently embark on the more deliberate economic reform that is urgently needed, but “home-initiated, formulated, and consented to by the IMF and the World Bank” and not the other way around (Mubarak, May 1, 1991). Egypt was to continue its leading role in the Arab World, the Middle East, and Africa as a peacemaker and a bulwark of stability.

Piecing these elements together, the shape of a vision of sorts was barely discernible as the Mubarak regime began its ERSAP. The message was one of “Egypt’s national independence being consolidated politically and economically. Its re-
gional leadership was asserted as a stable and strong peacemaker. Its future was charted on a reformed, sound economic base. Its education and manpower were to be revamped in preparation for the twenty-first century, while the basic needs of its poor and equity for all assured” (Mubarak, July 23, 1992). Meanwhile, the regime has continued to pride itself on “respecting basic freedoms and orderly democracy” (Mubarak, May 1, 1991).

**Test of Capacity: ERSAP Packaging**

The biggest concern of the regime in the implementation of ERSAP has been the working class. The consent of the middle classes and the support of the upper class were—mistakenly—taken for granted. Mubarak has been keen on eliciting the support of organized labor for ERSAP, or at least neutralizing its opposition. He regularly attends the Labor Day celebration (May 1st) organized by Egypt’s Federation of Labor Unions (EFLU). His second most important constituency has been Egyptian private investors. He has repeatedly visited their new industrial projects and held lengthy meetings with them in the new industrial towns (for example, Tenth of Ramadan and Sixth of October). The elements discussed below have been standard in Mubarak’s public discourse.

**Fear-Arousing Appeal**

Mubarak went to great lengths to show that without economic reform, the country would collapse: “without any exaggeration, our situation is awesome frightening. . . . For decades we have been consuming more than we are producing, and borrowing more than our ability to pay back. We are losing the trust of international financial institutions. The only other alternative to serious economic reform is total breakdown” (Mubarak, May 1, 1992). Economic reform was described as a bitter medicine, or even an “inevitable evil” (Mubarak, May 1, 1993). This fear-arousing technique was relatively effective during the first year of implementing ERSAP. There were very few expressions of labor unrest in 1991 (thirty incidents), but by 1992 and 1993, labor discontent grew dramatically (137 and 183 incidents, respectively) (ASR 1991–93).

**Blaming Previous Regimes and Their Policies**

Nasser blamed the prerevolutionary regime for neglecting the poor, the working classes, and the industrialization of Egypt; hence his remedy was “Socialist Transformation.” Sadat blamed some of Nasser’s policies for “closing Egypt” and the flight of national and foreign investors; hence his remedy of the “Infitah,” or Open-Door Economic Policy (ODEP). Mubarak blamed all three previous regimes: “It is our destiny to reform the structural imbalances accumulating since the end of World War II” (May 1, 1989). Nasser’s public sector and massive subsidies were blamed for losses and debts. Sadat’s ODEP was blamed for “excessive conspicuous consumerism and parasitic wealth in the hands of the few” (Mubarak, May 1, 1991).

**Evoking Patriotism**

In expounding the urgent need for economic reform, on public occasions Mubarak would reiterate how the working class has always been the vanguard of the Egyptian people in the great national battles of the past, and would restate his confidence that this will continue. “National pride soars with every product bearing ‘Made in Egypt.’ . . . Every drop of a worker’s sweat is like every soldier’s drop of blood, all for the renaissance of Egypt” (May 1, 1990). Mubarak would also emphasize that the proposed ERSAP is “an Egyptian scheme, blood and flesh, dictated by our own need assessment, taking our own social reality into account. . . . We are not doing it in response to dictate from international creditors or institutions” (Mubarak 1989). He would remind his fellow citizens of the economic conference he convened upon assuming office, emphasizing that economic reform has been high on his agenda and that he had tried his best to make it as gradual and as bearable as possible, until the time came for some harsh but inevitable measures (May 1, 1993).
Assuring Workers’ Interests

With ERSAP under way in the spring of 1991, Mubarak assured workers and public sector employees that neither their jobs nor their incomes would be adversely affected. If there is to be any privatization, “the government would make sure that no single worker will be out of a job. This is to be ensured through a variety of means, including retraining and rehiring” (Mubarak, May 1, 1992). The Egyptian president has been keen to promote ERSAP as “the only way to protect the real wage value against inflation; to generate more productive jobs for our youngsters; and to insure a better future for Egypt” (Mubarak, May 1, 1993).

Support for Low-Income Groups

Mubarak promised that during the “short hard times ahead, subsidies for bread will not be removed, we are planning to raise wages and salaries, but without sacrificing the objective of budget deficit reduction, which could only be done with production and productivity increase. . . . We are committed to helping the honest Egyptian citizen achieve his legitimate aspiration for a better life and to minimize his burdens. For that reason the Social Fund has been created. It is to extend aid to limited income groups and easy credit to youth to start their own small enterprises” (Mubarak, May 1, 1991).

Warning Against Neglect or Sabotage

Preparing workers for the hard times ahead, Mubarak asserted that he was keen on involving workers as “full partners in coping with the economic problems and challenges facing the country” (May 1, 1989), but reminded workers of past attempts of “the unpatriotic few to back-stab the country in times of difficulties to no avail, thanks to the majority of workers shielding national production” (May 1, 1991). He expressed his confidence that the Egyptian working class would remain alert and vigilant against irresponsible acts of neglect or sabotage (May 1, 1991). Apparently such warnings had a limited effect after the first year of ERSAP. The Arab Strategic Report did not report a single act of labor sabotage in 1991, but reported seventy-six in 1992 and eighty in 1993 (ASR 1991–93).

Mobilization of Investors

Mubarak frequently implored well-to-do Egyptians to save and invest at home, considering it a patriotic duty. In return, he assured them that it was his “duty to remove bureaucratic obstacles, pass the necessary laws and decrees to create the proper investment climate for them” (May 1, 1990). Cabinet members often accompany the president on his field visits to new investment projects, listen to complaints or requests, and often react to them on the spot, or immediately after the visit. All of this would be shown on the state television. This approach has had moderate success. A substantial part of the business community is still skeptical of the government’s total commitment to ERSAP, however, as indicated earlier.

Labor-Business Accord

The Mubarak regime persuaded labor and business leaders to hold joint meetings in the late 1980s and early 1990s to review the suggested ERSAP. By early 1991, a draft of a labor-business accord was issued, committing them to cooperation, both with one another and the state, to see Egypt through its economic difficulties. The accord was circulated and widely debated. Some members of EFLU had reservations; they felt it was tilted in favor of business (ASR 1991). But the regime used the nonbinding accord as a broad-based consensus on its anticipated ERSAP.

Privatization and Workers’ Partnership

The Mubarak regime has floated plans for public sector workers and employees to become shareholders in the newly privatized companies. This is to be done through easy credit from state banks or the Social Fund (ASR 1992). Government officials have gone to great lengths to
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assure workers and the public at large that such privatization is meant to improve management and raise productivity—"strategic industries" would not be privatized or sold to foreign investors, only "losing companies" will be put up for sale, and Egyptian and Arab investors would be given priority as buyers. The issue of privatization and schemes for public sector and worker partnership have been the subject of a lively debate in the last two years (Wahba 1994).

Future Compensators

The Biblical story of Joseph's vision of "seven lean years in Pharaonic Egypt to be followed by years of prosperity" was invoked by Mubarak as he implored Egyptians to work harder, consume less, and be patient. "We should all have good reasons for optimism after the few lean years needed to get out of the current bottleneck... we will all be better off in the years of plenty which lie ahead" (Mubarak, May 1, 1992).

President Mubarak has been the main, if not the only, spokesman and advocate in the packaging and promoting of ERSAP. The ruling elite have confined themselves to carrying out orders and implementing the ERSAP measures. To the extent that they spoke out at all, they displayed marked differences. Before the cabinet reshuffling in October 1993, four ministers ventured to address ERSAP. Two of them, the Minister of Industry, Mohammed Abdel Wahab, and the Minister of Labor, Assem Abdel-Haq, often contended that only losing public sector companies would be privatized and none would be liquidated (ASR 1991, 1992; interviews with the author in 1993). Two other cabinet members, Ahmed Sultan of Tourism and Atef Ebeid of Administrative Development, assured the Egyptian private sector, foreign investors, and international creditors that privatization was a general strategy that applied to all public companies, whether in bad or good shape (ASR 1991, 1992). Such discordant voices, all from the same government, left the citizens at home and interested parties abroad quite confused, at least during the first two years of ERSAP. After the reelection of President Mubarak to a third term and the formation of a new cabinet (October 1993), much of the discord diminished.

To what extent has the packaging and promotion of ERSAP been effective with the salient forces of Egyptian society? As indicated earlier, the Mubarak regime has been particularly keen on pacifying or neutralizing labor and winning over investors and the business class. It has also been attempting to neutralize opposition parties.

Public Discourse over ERSAP

When the Mubarak regime started ERSAP in 1991, it was already in its tenth year in office. Mubarak's packaging and promotion of ERSAP seems to have been lacking in effectiveness with the opposition. All major opposition parties and other social forces have had something negative to say about it. The right-of-center political parties, mainly the New Wafd Party (NWP) and the Liberal Party (LP), while agreeing with the need and principle of liberal economic reform, have expressed serious misgivings on its implementation, and more often on the absence of "political reform" that should have preceded or at least accompanied it. The left-of-center political forces, mainly the Arab Democratic Nasserite Party (ADNP) and the Progressive Unionist Party (PUP), have objected to ERSAP in principle, particularly because of the absence of "social reform" that should have preceded or accompanied it. More serious challenges, however, would come from trade unions, labor groups, and the Islamic camp, mainly the Socialist Labor Party (SLP), the Muslim Brothers (MB), and other militant Islamic groups. Below, we will sketch the reactions of these groups to ERSAP, in particular, and the Mubarak...
regime, in general, in the last three years of its implementation (1991–94).

**Labor's Response to ERSAP**

The modern Egyptian working class grew rapidly in the Nasser years (1952–70), thanks to his ambitious industrialization policy. Despite the many socioeconomic benefits for the working class under Nasser, he restricted their political autonomy in his corporate-style system. All trade unions were grouped by activity sector in one general union (for example, the General Union of Textile Workers Syndicates). All general unions were then organized in one “Egyptian Federation of Labor Unions” (EFLU) as of 1957. Despite this loss of autonomy, the Egyptian working class felt secure under Nasser. They were accorded benefits they had not asked for, or even aspired to gain (such as stipulating in the Constitution that a mandatory minimum of 50 percent of the seats in all elected bodies be reserved for workers and peasants after 1961). Following the 1961 Socialist Laws, a separate Ministry of Labor (MOL) was created, and it has become customary for the president of EFLU to assume the cabinet portfolio. Thus, the top leadership of EFLU was pacified by the regime. Under Sadat and Mubarak, however, organized labor has experienced growing alienation. The 1977 food riots, for example, were triggered by groups of workers on their way from a downtown Cairo commuter train station to the Helwan industrial district (20 kilometers south of the capital) (EFLU 1992).

During the first year of ERSAP, EFLU and its constituent general unions engaged the state in intensive discussions about the newly enacted Law 203 of 1991, the Public Business Sector Law, which was to overhaul state-owned companies. It provided for the creation of 30 holding companies with some 300 subsidiaries, and it gave their management broader and more flexible authority to reorganize and become more competitive to survive on their own, without state subsidy. Implicit and explicit in the parliamentary and public debate of Law 203 was the understanding that should a public company fail to live up to competitive market forces within a specified period, it would be sold or liquidated. Understandably, the new law created waves of negative reaction within the Egyptian working class, and there were many attempts by the regime and the top leadership of EFLU to allay the apprehensions and fears of workers (EFLU 1992).

In the second year of ERSAP (1992), some of those fears materialized. The Nile Company for Exporting Agricultural Crops (NCEAC) and the bigger and older Eastern Cotton Company were liquidated. Disputes, sit-ins, and demonstrations erupted in both companies. EFLU appealed to the prime minister, then to the president, to reconsider the liquidation decisions (ASR 1993; EFLU 1992).

Law 203 and its implementation have become the main point of disagreement between the regime and organized labor. The regime’s strategy of not reversing any of its ERSAP laws and measures has had several repercussions, including a growing, though silent, tension between the top leadership of EFLU and the regime, between EFLU and its constituent general unions, and between several general unions and their individual syndicates and local worker committees. Each level of the EFLU structure invariably charges the level just above with not standing firm enough on workers’ rights (ASR 1993).

With ERSAP well under way, it has become obvious that the corporate structure of EFLU is no longer functional. The constituent parts of EFLU have been increasingly acting on their own to defend their rights. They petition, demand, hold rallies, have sit-ins, stage strikes, and demonstrate without permission or support from the upper levels of EFLU. Workers’ petitions and demands involve the right to participate in decisions bearing on the future of their companies, immunity from arrest for engaging in peaceful demonstrations, and support funds for striking workers. Many of the strikes, sit-ins, and demonstrations reported...
Table 6
Expressions of Egypt's Labor Unrest, 1990–93

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<td>Strikes</td>
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<td>137</td>
<td>183</td>
<td>1,830</td>
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<td>33</td>
<td>40</td>
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<td>76</td>
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<td><strong>Total</strong></td>
<td>18</td>
<td>34</td>
<td>170</td>
<td>223</td>
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Source: Compiled from the list of al-Ahram's Arab Strategic Report (ASR).

since 1990 have to do with these union demands, but have focused more specifically on wages, fir-nings, and the liquidations of whole companies. The Arab Strategic Report (ASR) listed workers’ strikes, demonstrations, and sabotage as having risen from 10 in 1990, to 30 in 1991, to 137 in 1992, and to 183 in 1993—a 1,830 percent increase in four years, as shown in Table 6 (ASR 1990, 1991, 1992). The eighteenfold increase in labor unrest between 1990 and 1993 has created an ominous side-effect: the Central Security Forces (CSF), specialized in quelling uprisings and mass rioting, have been called in with increasing frequency to break workers’ strikes and demonstrations. They were called upon three times in 1991 and eleven times in 1993. While no one was reported killed, many were wounded. It is worth noting that no serious acts of sabotage were reported, despite the rising incidents of labor unrest. Egypt’s privatization program is still in its early stages. Some 200 public companies are to be privatized in 1994–95 (al-Ahram, June 15, 1994). Should these plans go forward, more labor unrest is to be expected.

The Opposition Parties and ERSAP

Egypt currently has thirteen legally licensed political parties. Other than the ruling NDP, only five have any political weight. In order of importance, as indicated by previous election results, they are: the New Waf Party (NWP), the Arab Democratic Nasserite Party (ADNP), the Socialist Labor Party (SLP), the Progressive Unionist Party (PUP), and the Liberal Party (LP). The other seven are too small or too new to have any impact on the current Egyptian political scene. We will only outline here the discourse advanced by the five significant opposition parties over ERSAP and the Mubarak regime.

The NWP and LP are in general agreement with the Mubarak regime on the need for ERSAP. The NWP predates the 1952 Revolution; it goes back to the 1919 Revolution. Although dissolved by decree in 1954, it resurfaced in 1977 when a multiparty system was reinstated. It has a well-established liberal tradition, and it now represents the old, landed bourgeoisie; the well-to-do professionals; and the upper-middle class. The LP’s constituency consists of middle-class professionals and small entrepreneurs. The NWP’s objection is not to the principles of ERSAP, but to its implementation in a totally “unhealthy political situation, at the hands of an unqualified, inept, and corrupt ruling regime” (Abaza 1994).

The NWP also believes that “because the regime has dragged its feet for ten years, it now has to accept the humiliating conditions of the IMF and other international creditors. This has meant a hasty implementation of economic reform which has led to grave sociopolitical consequences.” Among the latter is growing discontent, some of which is expressed in armed resistance to authority. This, in turn, has led the government to become more dictatorial. Thus, “we are now suffering from two evils: The regime’s dictatorship and counter-violence, and the terrorism of some of the discontented” (Abaza 1994). The way out of this dual predicament was outlined recently by NWP Chairman Fou’ad Serag Eldin: “The prerequisite of successful economic, social, and educational

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39 Law 40 of 1977 regulates the establishment of political parties. The law is very restrictive and places the licensing squarely in a government committee dominated by the ruling party. Nine of the existing thirteen parties were initially denied licensing, and they had to go to court to get it.
reform is political reform, which means constitutional change to ensure fair and honest elections under judiciary supervision and peaceful change of government" (Serag Eldin 1994).

The same NWP views on ERSAP are echoed by the smaller LP. The only added emphasis by the LP is its concern over the harm that some of the ERSAP’s measures may cause to Egypt’s budding industrial capitalism—for example, the reduction or removal of tariff protection. LP has also been vocal against the sales tax (introduced in 1992), because it was imposed across the board, including inputs of production, which raises prices for end-users of Egyptian products at home and makes them less competitive on the international market. As the LP leader puts it, “such contradictions are evidence that the NDP policymakers are inept and self-defeating” (Murad 1994).

Neither the NWP nor the LP perceive the Mubarak regime as having a well-articulated “national project,” or a broad-based consensus around ERSAP or any of its other public policies. Spokesmen for both parties view ERSAP as “a stop-gap measure done under external pressure and not out of real conviction” (Abaza 1994; Murad 1994). In brief, the two parties, which are often seen as right-of-center, agree with the Mubarak regime on the dire need for ERSAP, but they disagree with the regime on nearly everything else—timing, implementation, and absence of other conditions of success.

Two other important legal opposition parties, PUP and ADNP, are generally viewed as left-of-center. Both oppose ERSAP in principle. The economic spokesman of PUP, Dr. Gouda Abdel-Khalak, calls it “economic deform.” He contends that “it stunts Egypt’s economic growth and impoverishes the masses. There were several alternatives to the course taken by our government. But the latter lacks economic and political imagination; and has not been willing to listen to those who have it. Our party (PUP), has submitted comprehensive proposals as early as the 1982 Economic Conference. We have updated those proposals; but the regime has continued to ignore them because it is aversive to anything that comes from popular forces. The economic policy of the regime is a product of bureaucratic-technocratic-parasite forces with no political vision” (Abdel-Khalak 1994).

The views of the ADNP on ERSAP are essentially the same. A prominent economist and former Minister of Planning, M. M. El-Imam, maintains that ERSAP is still command economics, “but the commander is no longer the Egyptian state, but the IMF and the World Bank. The Egyptian state has become a mere implementor and a watchman” (El-Imam 1993). ADNP’s major concerns are social equity, economic development, and preservation of Egyptian independence. The party sees the three goals as having been sacrificed at the “altar of the IMF” (see al-Arabi editorials, April 5, May 8, 1994). The alternative to externally imposed ERSAP, for both PUP and ADNP, is the rehabilitation of the public sector, support for national capitalism, combating corruption, progressive taxation, human development, and Arab regional integration (al-Ahali; al-Arabi editorials, 1993, 1994).

The fifth major legal opposition party is the SLP. Deputy Chairman Helmy Murad and Secretary General Adel Hussein are prominent Egyptian economists. Their weekly columns in the SLP’s al-Shaab reflect the party’s views on ERSAP. Both have maintained the same objections in principle to ERSAP as PUP and ADNP. Egypt’s economic ills as seen by SLP economists are the result of waste and corruption at home and “conspiracies” from abroad (A. Hussein, al-Shaab, April 1, April 8, 1993). Exposing corruption at home has been the crusade of Dr. Helmy Murad for years, and for his efforts he has frequently been detained for interrogation by the authorities on charges of inciting public opinion by sensational accusations, some of which touched cabinet members and President Mubarak’s own children (al-Shaab, September 14, 21, 28, 1993).
Successful Adjustment and Declining Governance? The Case of Egypt

In 1987 the SLP joined with the MB to form the Islamic Alternative (IA), entered the parliamentary elections the same year, and won sixty-five seats. It made the IA the second largest bloc in Egypt’s People’s Assembly (the Parliament) after the ruling NDP (with 370 seats). This impressive showing has tempted the SLP to move steadily toward an Islamic discourse. Thus, while it shares with PUP and ADNP a total rejection of ERSAP, the SLP has proposed an “Islamic alternative” to deliver Egypt from its chronic ills. Ambiguously defined as it may be, the Islamic alternative in economics calls for banning “interest” (considered usury); repugnant economic and commercial activities (such as the production or sale of liquor); and substituting Zakat (alms tax, which amounts to 2.5 percent of annual wealth) for the current taxation systems, built on Western models; and internalizing the Islamic work ethics and values of austerity and compassionate mutual help (takaful) throughout society. A regular columnist in the SLP biweekly, Mustafa Mashhour, promulgates these ideas of Islamic economics (see al-Shaab, January 4, February 15, March 1, April 26, June 14, 1994).

But more important to the issue of governance is the SLP’s tacit defense of the more militant Islamic activists. Stopping short of endorsing their terrorist acts, SLP has invariably blamed government policies, including ERSAP, for the mass unemployment, social injustice, and corruption that drive young Egyptians to despair and “unfortunate acts” (rarely, if ever, described as terrorism). Meanwhile, the Egyptian government’s abridgement of Islamists’ human rights are dramatized (see al-Shaab editorials, September 17, 24, 1993; January 4, 7, 11, 14; May 16, 23; June 3, 10, 17, 1994).

Since the late 1970s, the SLP’s newspaper, al-Shaab, had been a weekly with a circulation of about 50,000. In early 1992, it began to publish twice a week, and its circulation quadrupled to about 200,000 by mid-1994. This jump in popularity coincided with both the initiation of ERSAP and the escalation of violent confrontations between the state and militant Islamic groups. SLP and its newspaper have become the most vehement critics of the Mubarak regime, the West, and Israel. It has also become the main source of alternative news and the defense of Islamic militants.

Nearly all of Egypt’s opposition parties had become alienated from the Mubarak regime by mid-1993. One expression of that alienation was their boycott of Mubarak’s reelection for a third term; another was their willingness to stand by as the regime battled with violent Islamists. Sensing this growing estrangement, Mubarak called for a “national dialogue” with the opposition in his inauguration speech (October 13, 1993). The opposition parties initially responded positively to the presidential invitation. Some eight months passed, however, before any concrete steps were taken to start the dialogue. The first step declared by the president, in mid-May 1994, was the naming of a forty-person preparatory committee and the announcement of an agenda of four topics for the dialogue. Thirty out of the forty committee members were also NDP members, and the four topics (economic, social, and educational reform and guarding national unity) did not include “political reform.” The opposition parties considered the step insulting, and two of the major parties, NWP and ADNP, withdrew from the dialogue on the first day. The other opposition parties expressed their dismay over what were considered “condescending and heavy-handed procedures” (al-Wafd, June 1, 1994). With the exclusion of the Muslim Brotherhood from the start, the prospects for the national dialogue did not seem promising. Alienating these three major opposition forces, the Mubarak regime missed one more opportunity to create a minimal national consensus for ERSAP and other major public policies.

Politics of Alienation

The regime’s reluctance to engage in serious participatory politics, let alone power-sharing, has led
to a steadily mounting alienation of growing segments of the public and to a mass desertion of professional groups. Many younger professionals have taken shelter in Islamic activism. In other words, a dearth of politics of participation has led to politics of alienation and, in extreme cases, violent anger.

An Alienated Civil Society

Despite the qualified support that the regime enjoyed from all five major opposition parties until 1990, it was unable to retain it. The following three years (1991–94) witnessed a steady erosion of support, including that of the two parties that accepted ERSAP in principle, the NWP and LP. The other three parties have totally rejected ERSAP and have grown increasingly hostile to the regime’s public policies. In this section, we examine the other salient forces of Egypt’s civil society, mainly the professional associations (PAs, or, as they are called in Egypt, “syndicates,” al-niqbat al-Mihaniyya). There are twenty-one such associations, with a total membership of about 3.0 million professionals, or 20 percent of Egypt’s total labor force. They differ markedly from workers’ trade unions: their members are university graduates with white-collar occupations. The PAs are Egypt’s organizational embodiment of its intelligentsia. They are the backbone of what M. Halpern (1963) calls the “new middle class” (NMC), a social group that has been the most dynamic political force in the country since its modern re-emergence over a century and a half ago. The NMC enjoyed many privileges in the Nasser era, but its younger members, lower down on the professional ladder, have seen their income and prestige deteriorate under Sadat’s ODEP and Mubarak’s ERSAP. Their discontent has been expressed peacefully by many, and violently by a few. Making up some 60.0 percent of the membership of PAs, this group, counting as members those under the age of forty, have voted in increasing numbers for the antigovernment candidates, most of whom are MB members. By 1993, six of the seven biggest and most important PAs were controlled by Islamists, including the lawyers, engineers, doctors, pharmacists, dentists, and commerce graduates (see table 7).

The Teachers’ Syndicate is the only major PA not totally under the control of the Islamists. The government’s reaction to this peaceful shift of control in the PAs was to issue Law 100 of 1993, which mandated a 50.0 percent quorum of all members for election results to be valid.  

| Table 7 | Islamist and Secularist Representation on the Boards of Major Professional Syndicates in 1993 |
|-------------------|-------------------|-------------------|
| Syndicate         | Islamists         | Secularists       |
| Lawyers           | 18                | 6                 |
| Engineers         | 21                | 3                 |
| Doctors           | 21                | 3                 |
| Pharmacists       | 23                | 3                 |
| Dentists          | 7                 | 5                 |
| Commercial        | 23                | 17                |

Source: Division of Minorities Affairs (DMA), Ibn Khaldun Center for Development Studies.

During recent violent confrontations with Islamists, security forces complained that eyewitnesses, especially in Upper Egyptian villages, do not cooperate with them. Elected village mayors were blamed for this lack of cooperation. The regime’s response was to pass a law in April 1994

40 With more than a two-thirds majority for the ruling NDP in the People’s Assembly, the government could pass any law on a few hours notice.
that did away with the election system of village mayors. Now they are to be appointed by the Ministry of Interior (CSDTAW Newsletter, May 1994).

Another important area of contention between the opposition and the Mubarak regime has been Egypt's fourteen universities. In both the faculty and student populations, progovernment elements have come a distant second or third in campus elections. While unable to do much with student elections yet, the government surprised Egyptian professors in May 1994 by amending the Universities Law 49 of 1972, changing the system from the election of deans and department chairmen to one of appointment by the minister of education. The draft of the amended law was never debated by the academic community or the Parliament, and this was considered an insult to Egyptian academics, including those who are on good terms with the regime (al-Ahali, June 8, 1994).

In addition to political parties, professional associations, and universities, Egypt has some 14,000 private voluntary organizations (PVOs). Despite a restrictive law (No. 32 of 1964), nonviolent Islamic groups have managed to establish or take over the boards of nearly half of the PVOs. During the October 1992 Cairo earthquake, within hours the Islamist-controlled PVOs and PAs managed to outdo the government in relief efforts. The foreign media (CNN, for example) took note, and highlighted the difference. The regime’s reaction to this unflattering publicity was to decree a ban on direct relief efforts by PVOs—efforts would be channeled through the government. When this help did not materialize in time, several riots broke out in the afflicted districts of Cairo (CSDTAW Newsletter, November 1992). The earthquake episode is only one case that illustrates the regime’s limitations in providing goods and services to needy Egyptians, while at the same time hindering those who could provide assistance for fear that Islamic PVOs would gain political advantage at the government’s expense.

All in all, the salient forces of Egypt’s civil society have increasingly been alienated from the Mubarak regime. Although nonviolent by definition and practice, these forces have been subject to increasing pressures and restrictions from the regime. In turn, they have escalated their criticism of the regime’s public policies, including ERSAP. The doctors’, engineers’, and lawyers’ associations organized conferences and seminars to debate ERSAP during 1992 and 1993. The tone of those debates was quite critical. Many of their conclusions differed little from those of political opposition parties—that there is a dire need for concomitant sociopolitical reform (CSDTAW 1993).

**Politically Motivated Violence**

Probably the clearest test of governance is the ability of a ruling regime to maintain law and order. While nonviolent Islamists have gained ascendance over many of the alienated and discontented Egyptians, some of the latter have opted to challenge the regime through violent means. Although much smaller in numbers, more militant Islamic groups—the Jihad, the Takfir wal Hijra (TWH), and the Jama’a Islamiya (JI)—are the ones that have captured the headlines, embarrassing the Egyptian state since 1974. To be sure, politically motivated violence has not been the monopoly of Islamic militants. In modern Egyptian history, other political groups have indulged in violence, but it is the militant Islamic activists who have been identified with such violence recently.

Table 8 shows selective indicators of sociopolitical unrest in Egypt since 1952. Some of this unrest was spontaneous, such as rioting,

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41 Jihad means struggle in the name of God, and is popularly translated as Holy War; Takfir wal Hijra means repentance and Holy Flight; and Jama’a Islamiya means the Islamic Group.
Table 8
Selective Indicators of Sociopolitical Unrest, 1952–93

<table>
<thead>
<tr>
<th>Indicator</th>
<th>1952–70 Nasser years (%)</th>
<th>1971–81 Sadat years (%)</th>
<th>1982–93 Mubarak years (%)</th>
<th>Total</th>
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<td>2 (7)</td>
<td>13 (42)</td>
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<td>2 (11)</td>
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<td>7. Arrests (detention orders)</td>
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<td>42 (24)</td>
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<td>9. Death sentences</td>
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<td>12. Annual average</td>
<td>783</td>
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Note: Numbers in parentheses represent percentages.
Source: Ibn Khaldoun Center for Development Studies, files of Islamic Activism Research Project.

while other instances were instigated by interest groups (for example, workers and students). Much of the sociopolitical unrest relates to Islamic activists during the three successive regimes of Nasser, Sadat, and Mubarak. Table 8 indicates a quantum jump in the incidence of unrest from one regime to the next. The annual average of such incidents doubled between the Nasser and the Sadat years, then tripled between the Nasser and Mubarak years. Like all averages, however, those in line 12 of table 8 conceal the specific events of particular years and subperiods within each regime. In the Nasser period, much of the unrest was in the early years (1950s); in Sadat’s time, it was in the later years (1977 to 1981); and during Mubarak’s tenure, it has been quite recent (since 1990). This observation renders the demographic explanation of the volume of unrest less important.

This point is further illustrated by a closer examination of data related to politically motivated violence during Mubarak’s twelve-year presidency. For example, line 10 of table 8 shows the number of casualties (killed and wounded) of politically motivated violence. During the forty-two years since 1952, there were 1,811 casualties, 86.0 percent of which occurred in the last twelve years, during Mubarak’s presidential tenure. Still more dramatic is that during the first six years (1982–88) of Mubarak’s presidency, there was little violence—a total of 33 casualties, averaging less than 5 casualties annually. The last four years (1990–93) were by far the bloodiest, not only during Mubarak’s presidency, but also of this century. There were 1,164 casualties, an average of 291 casualties annually. To put it differently, of the twelve years of Mubarak’s presidency, the last four have appropriated nearly 92.0 percent of all the casualties from politically motivated violence.

The specter of political violence took on its most fearsome aspect in the two years following the implementation of ERSAP, 1992 and 1993. Tables 9 and 10 list details of the casualties of security forces, Islamic activists, and civilian bystanders. Some ominous observations are worth noting. First, the number of total casualties in 1993 was nearly four times that of 1992 (1,106 com-
Successful Adjustment and Declining Governance? The Case of Egypt

Table 9
Scoreboard of Political Violence, 1992

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Source: Compiled from Ibn Khaldoun Center Files of Islamic Activism Research Project.

Table 10
Scoreboard of Political Violence, 1993

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<td>29</td>
<td>149</td>
<td>147</td>
<td>105</td>
<td>28</td>
<td>58</td>
<td>774</td>
</tr>
<tr>
<td>Casualties</td>
<td>22</td>
<td>45</td>
<td>183</td>
<td>37</td>
<td>56</td>
<td>70</td>
<td>41</td>
<td>177</td>
<td>159</td>
<td>132</td>
<td>41</td>
<td>124</td>
<td>1,106</td>
</tr>
<tr>
<td>Arrested</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civilians</td>
<td>159</td>
<td>4</td>
<td>265</td>
<td>-</td>
<td>2</td>
<td>-</td>
<td>111</td>
<td>5</td>
<td>6</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>594</td>
</tr>
<tr>
<td>Extremists</td>
<td>1,231</td>
<td>1,251</td>
<td>1,884</td>
<td>1,497</td>
<td>1,049</td>
<td>1,537</td>
<td>866</td>
<td>1,405</td>
<td>2,338</td>
<td>1,386</td>
<td>1,470</td>
<td>1,277</td>
<td>17,191</td>
</tr>
</tbody>
</table>

Source: Compiled from Ibn Khaldoun Center Files of Islamic Activism Research Project.
pared with 322). Second, while the total number of casualties of Islamid activists was twice that of the security forces in 1992 (122 compared with 61), in 1993 the two figures indicate a growing parity (363 vs. 301). Of those killed, there were more policemen (120) than Islamic activists (111) in 1993. Third, in both years the number of civilian casualties caught in the cross-fire exceeded both police and activist casualties (139 and 442 in 1992 and 1993, respectively).

During this period, several assassination attempts were made on the lives of high-ranking public figures by Islamic activists. Two of the attempts succeeded: Dr. R. al-Mahgoub, the former Speaker of Parliament (October 1990), and Dr. Farag Fouda, Egypt’s most outspoken secular intellectual (June 1992), were both killed. The activists also managed to assassinate four police generals, including the top antiterrorist ranking officer (General R. Khayrat, on April 9, 1994). There were close attempts on the lives of two cabinet members (of the Ministries of Information and the Interior in April and August 1993, respectively) and on the prime minister in November 1993. A similar attempt was made on a renowned novelist, the 1988 Nobel prize winner Naguib Mahfouz, on October 14, 1994. All four attempts led to wounding of their targets.

By all counts, 1993 was the year in which the violent Islamic activists seemed to have had the upper hand in armed confrontations. They were more daring than ever before. They took the initiatives in operations, and often outmaneuvered the government forces. Their choice of targets widened to include Christian Copts, secular Muslim thinkers, foreign tourists, and whatever they considered repugnant—cinemas, cafes, video shops, Nile cruisers, and the like. Their methods also showed greater sophistication. Not only did they demonstrate skillful use of arms, explosives, and remote control devices, but they also manufactured some of these devices themselves. They displayed remarkable abilities in their intelligence system. Some of these upgraded skills were no doubt the result of experience accumulated over the previous two decades, but equally important is the combat experience many of them acquired as volunteers with the Mujahideen in Afghanistan against Soviet occupation forces during the 1980s. As a result, their operations in the last three years became more protracted—from hours or days in the 1970s to weeks and months in the 1990s.

Unlike their counterparts in the 1970s and early 1980s, Egypt’s Islamic militants of the 1990s acquired modern communication skills that were used effectively in psychological warfare against the Egyptian state and in gaining maximum exposure. For example, among the 1,557 casualties during Mubarak’s tenure, only 11 were foreign tourists. But that tiny figure (compared with what happened in the United Kingdom or in the state of Florida during the same period) resulted in the destruction of two tourist seasons (1992 and 1993), depriving Egypt of badly needed currency (estimated at US$3.0 billion). In short, the activists’ confrontations with the Egyptian state had become a “war of attrition” by 1993 (Ibrahim 1994).

The greatest change of all was embodied in the socioeconomic profile of the Islamic militants of the 1990s. Compared with their counterparts in the two previous decades, they were younger and less educated. Many came from rural, small-town, and shantytown backgrounds. Table 11 presents some comparisons compiled from data on those killed, wounded, and arrested. The average age of Islamic militants arrested and charged for acts of violence dropped from twenty-seven years in the 1970s to twenty-one in the 1990s. Of the thirty militants arrested, tried, and convicted for attacks on tourists, seven received death sentences in December 1993. Three of them were below the age of twenty (nineteen, eighteen, and sixteen years of age). There also has been a sharp drop in the formal education of Islamic activists arrested and charged for acts of violence. In the 1970s, as many as 80.0 percent were college students or graduates. In the 1990s, that percentage dropped to 20.0, and among them, those who were stu-
Table 11
Socioeconomic Profile of Egypt's Islamic Militants, 1970s–90s

<table>
<thead>
<tr>
<th>Percent</th>
<th>1970s</th>
<th>1980s</th>
<th>1990s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than 20 years</td>
<td>5.0</td>
<td>11.0</td>
<td>23.0</td>
</tr>
<tr>
<td>20–25 years</td>
<td>28.0</td>
<td>31.0</td>
<td>48.0</td>
</tr>
<tr>
<td>25–30 years</td>
<td>61.0</td>
<td>53.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Above 30 years</td>
<td>6.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Education</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Below secondary</td>
<td>2.0</td>
<td>5.0</td>
<td>9.0</td>
</tr>
<tr>
<td>Secondary</td>
<td>8.0</td>
<td>12.0</td>
<td>29.0</td>
</tr>
<tr>
<td>Junior college</td>
<td>11.0</td>
<td>24.0</td>
<td>42.0</td>
</tr>
<tr>
<td>College and postgraduate</td>
<td>79.0</td>
<td>59.0</td>
<td>20.0</td>
</tr>
<tr>
<td>Elite majors (e.g., medicine)</td>
<td>51.0</td>
<td>27.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Residence</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Villages</td>
<td>0.0</td>
<td>7.0</td>
<td>18.0</td>
</tr>
<tr>
<td>Shantytowns (Ashwai'iat)</td>
<td>8.0</td>
<td>16.0</td>
<td>36.0</td>
</tr>
<tr>
<td>Towns</td>
<td>37.0</td>
<td>43.0</td>
<td>31.0</td>
</tr>
<tr>
<td>Large cities</td>
<td>55.0</td>
<td>34.0</td>
<td>15.0</td>
</tr>
</tbody>
</table>

Source: Ibn Khaldoun Center Data Files of Islamic Activism Research Project.

Table 11 shows that the degree of alienation and discontent that drives extremism has now spread to younger and less-educated Egyptians. This may in part explain their disposition toward lethal violence. As table 11 illustrates, the same sense of despair seems to have spread from large cities (55 percent in the 1970s compared with 15.0 percent in the 1990s) to rural areas and shantytowns in the 1990s (8.0 percent in the 1970s compared with 54.0 percent in the 1990s). It is ominous that while there were no rural residents among the activists arrested in the 1970s, the Egyptian public began to hear for the first time about villages (such as Sanabou, Walidiya, and Salamoun) in the Governorate of Assyut as scenes of sustained armed confrontations between Islamic militants and the state security forces. The same is true of a new scene of such confrontations, the so-called "Ashwai'iat," or shantytowns, on the rural-urban fringes of major cities. Although these areas accounted for fewer than 8.0 percent of the arrested and charged militants in the 1970s, their share jumped to 36.0 percent in the 1990s. A case in point is a shantytown by the name of Western Munira on the edges of the old district of Embaba, Giza, across the Nile from Cairo's elite suburb of Zamalek.

Covering about the same area as Zamalek (16.0 square kilometers), Western Munira has more than ten times the population. With no schools, hospitals, clubs, sewage system, public transportation, or police station, the highly dense Western Munira had become a "Hobsian" world of violence and vice by the late 1980s. A small group of Islamic militants led by a twenty-seven-year-old man, Sheikh Jaber, took over Western Munira and essentially ruled it for three years, collecting taxes and imposing their own law and order and Islamic codes of morality. In December 1992, the Egyptian state finally took note of what was happening. It dispatched some 12,000 security forces with armored vehicles to conquer Western Munira. It took three weeks, some one hundred casualties (from both sides), and the arrest of some 600 suspected militants before Western Munira was pacified (CSDTAW 1992).

In brief, the amount of politically motivated violence during President Mubarak's twelve-year tenure far exceeds that of the nearly thirty years of his two predecessors, Nasser and Sadat. The amount of such violence in the last four years of Mubarak's tenure (1990–93) equals that of the previous thirty-eight years, including the administrations of Nasser and Sadat and first eight years of Mubarak's. Those last four years have coincided with implementation of ERSAP.

Deteriorating Human Rights and Feelings of Insecurity

One clear victim of the escalating violence in Egypt is human rights. The Egyptian Organization for Human Rights (EOHR) has documented the kinds of violations committed by the govern-
ment for years. These incidents were confirmed by the U.S. Department of State in its annual *Country Reports on Human Rights, Egypt*, and by independent researchers (McDaid 1994). Two new elements have been noted in the last three years. The first is the issuance of several laws further restricting basic freedoms by expanding the executive branch’s authority to detain citizens without charges and authorizing the trial of civilians by military courts, where due process is not as stringent (EOHR 1992). The second is the increase in violations of human rights by nonstate actors, primarily militant Islamic groups (EOHR 1992).

These developments have resulted in a collective sense of insecurity among Egyptians. In a recently commissioned national sample survey by the United Nations Development Program (UNDP) and Egypt’s Institute of National Planning (INP), it was revealed that more Egyptians felt insecure in all areas of life in 1993 (52.0 percent) than in 1992 (37.0 percent). The comparison was even more stark between the present and five years earlier—nearly three times as many Egyptians (67.0 percent) said they are less secure now than they were five years before (23.0 percent reported the opposite) (UNDP/INP 1993).

In the basic, though narrower, sense of “physical safety,” 20.9 percent reported being less safe in 1993, compared with 21.0 percent in 1992 and 8.0 percent in 1988 (UNDP/INP 1993). In addition, more people were less secure about their jobs (22.0 percent, 17.0 percent, and 6.0 percent in the three periods of time, respectively). The same study revealed dissatisfaction with present levels of income (39.0 percent), housing (29.0 percent), food security (31.0 percent), and ability to secure medication should the need arise (41.0 percent) (UNDP/INP 1993).

This attitudinal assessment is confirmed by aggregate data compiled and indexed by the UNDP *Human Development Report (HDR)* for various years, both over time and in comparison with other countries. Between the 1990 and 1993 HDR, Egypt’s rank has slipped from 110 to 124 among the countries covered (UNDP 1990, 1993). Despite the country’s progress on several development indicators, the main depressor of Egypt’s rank seems to have been the drop of income per capita from nearly $710 in 1988 to $610 in 1993.

It is worth noting that the overall sense of security among Egyptians varied markedly between Upper Egyptian Governorates and those of Lower Egypt. This attitudinal variation resonated in Egypt’s Human Development Index (HDI). The less secure Upper Egyptians had a score of 0.373 on the HDI, compared with 0.440 for Lower Egyptians and 0.568 for the urban governorates (Cairo, Alexandria, Port Said, and Suez) (INP 1994). More than 65.0 percent of the politically motivated violence discussed earlier was concentrated in Upper Egyptian governorates.

**Conclusions**

The relationship between ERSAP and governance in Egypt has not been a unitary one. On first glance, the Egyptian case reveals relative success in the former and relative failure in the latter. While the regional and international factors were conducive to Egypt’s timing of ERSAP, the domestic factors were mixed. Both governance and ERSAP are complex variables, which are best disaggregated, with the components cross-related. For example, gover-
nance may be defined as the capacity to mobilize, control, regulate, and coordinate to get things done. As such, it entails the elite’s mastery and deployment of means of inspiration (vision) as well as means of coercion (state violence or terror), with a host of other institutional means in between (for example, legislative, judiciary, media, or civil society).

By the same token, ERSAP entails fiscal reforms, currency stabilization, liberalization of trade, privatization, and the like. Some of these measures (such as stabilization) could be formulated, initiated, and completed successfully by a small, insulated team of able technocrats tied to the top decisionmaker (a president or prime minister). These measures neither require much attitudinal change nor the massive involvement of the bureaucracy. Their direct impact on various constituencies may not be immediately felt. Other measures of ERSAP, such as privatization, involve a greater number of actors, opposing vested interests, and heated passions.

To be tested properly, the hypotheses relating governance to ERSAP must be broken down into several subhypotheses to account for the nature and direction of specific correlations among the subcomponents. For example, much of the initial success of Egypt’s ERSAP was because it only involved stabilization under favorable regional and international timing, with no direct or immediate impact on the mass of Egyptians. Thus, even when the politically active opposition parties opposed those measures, the regime’s governance capacity was neither fully deployed nor fully tested. The outcome of the first phase of Egypt’s ERSAP (1991) was a success. The real test began with the second phase (1992). The story here becomes quite mixed: there has been some measure of success in ERSAP, but at a very high human and sociopolitical cost. The increase in coercion means that the regime’s governance arsenal is being used.

In retrospect, much of this heavy cost may have been averted. There was a time in which both external and internal factors were mutually enhancing. This was during President Mubarak’s first term in office (1981–87). Remittances, oil prices, tourism, and foreign aid were still relatively high. Mubarak was enjoying a grace period (or honeymoon). Egyptians’ expectations of him were quite modest, and they were tuned to the imperatives of economic reform after the 1982 economic conference he convened. After delaying economic reform for nearly ten years, for Mubarak’s ERSAP to succeed sociopolitically as well as economically, he had to couple it with a compelling “vision” or a “national project.” He has only recently tried to do this, but it seems to come too late and to be too slight an effort. The actual or potential gainers from ERSAP could have provided a political base to support him during the inevitably lean initial years. But most of them have not clearly recognized the actual or potential gains. Those who may have seen the advantages are either too scattered or are organized under different banners, such as the NWP and LP. As such, they would only lend political support in return for some kind of a power-sharing scheme, which Mubarak and his entourage have so far been reluctant to even consider.

While all Egyptians may be better-off in the long run as a result of a successful ERSAP, what matters politically is the short run. That is when the losers feel the outcome. If they are many and have nothing or little more to lose, the potential for collective unrest grows proportionately. The four main social groups that have steadily, clearly, or amorphously experienced this situation in Egypt during the last four years are: (1) the modern working class (MWC), (2) the urban poor, (3) the young, and (4) the new middle class (NMC). At some point during the first three years of ERSAP, they have all seen their material conditions deteriorate, with little moral or spiritual compensation in return in the present, or delayed but credible material payoff in the future. The function of a “vision” or a “national project” is precisely the provision of such current moral and spiritual com-
Governance, Leadership, and Communication: Building Constituencies for Economic Reform

The Egyptian regime seemed to have provided neither to the four main social groups when ERSAP was implemented in 1991. Had the regime not wasted the honeymoon—introduced ERSAP ten years earlier, when Mubarak took over—it would at least have had the benefit of the doubt on whatever future compensations it might have promised. But with ten years of a record ranging between modest and dismal performance, it was unlikely to get that benefit again, especially from the social groups that had already been losing before ERSAP; hence, they have become disposed to confront the Mubarak regime sooner rather than later.

These four alienated groups make up the vast majority of Egyptians, with each differing in size, composition, and political subculture. The reactions of each to ERSAP and the mode of action against the regime were also bound to be different. The NMC’s preferred mode of action has been through the PAs, and the peaceful quest for democracy, human rights, decent employment, and adequate income. The MWC’s preferred mode of expressing discontent has been through peaceful and quasi-peaceful sit-ins, strikes, and demonstrations. The urban poor, outside modern economic institutions, are what Marx dubbed the urban “Lumpen Proletariat” (ULP). In the Egyptian case, the ULP is now concentrated in slum areas (Ashwai’iat). The ULP is disposed to rioting upon medium-intensity provocation, and hence is easily manipulated. Young, educated Egyptians represent the raw and most sensitive nerves of society at present. Their discontent is channeled either through PAs or more militant and violence-prone Islamic groups. We have seen marked increases in all indicators of unrest covering these modes of action.

The Mubarak regime has been slow to perceive the early signs of discontent in each of the four main social groups, and when it finally sees a problem, it often overreacts. The recent confrontations with the Lawyers Association (Syndicate) is the latest case in point.43

Furthermore, the regime has barely resorted to “political” means in managing the growing discontent, much less socioeconomic measures to deal with its root causes. The regime’s favorite way of dealing with discontent is to resort to security measures, followed by a state media blitz. Disregard for due process and abridgment of human rights have become rampant in the last three years (1991–94). The short supply of political imagination of the ruling elite and the nearly complete absence of elite circulation have worsened the situation. The average age of present cabinet members is sixty-three (it would have been sixty-seven if not for the appointment in October 1993 of two new members—out of thirty—in their forties). The average age of an average Islamic militant, as we saw, is twenty-one, which means there is a gap of forty-two years, or nearly two generations, between the two groups. The hardening of Egypt’s political arteries is made worse by a heavy and inefficient bureaucracy. Demoralized and increasingly impoverished, its upper levels have become disposed to grand corruption, and its lower

43 A lawyer, Abdel Haris Madany, suspected to have a connection with an Islamic militant group, was arrested in his law office on the night of April 26, 1994. The security forces took him to his apartment, which was searched; then he was detained in their custody. Several days later, the authorities informed his family of his death of “natural causes.” When the family arrived, his body was in a sealed coffin, and their request for an autopsy was denied. The Lawyers Syndicate, which is controlled by the Muslim Brotherhood, insisted on an autopsy, suspecting torture. When the request was denied again, the syndicate board declared a “sit-in.” With no favorable response from the authorities, they declared a strike (work stoppage for an hour in courts) on May 15, in which some 100,000 lawyers all over Egypt are said to have participated. Still unwilling to budge, the syndicate declared a peaceful march to the Abdeen Presidential Palace (3 kilometers from the syndicate). Warned by security against marching, the lawyers did not heed the warning. As soon as some 300 lawyers stepped out into the street, the police opened tear gas, physically clashed with the would-be marchers, arrested and detained 37 of them, and dispersed the rest. Over a month later the lawyers were still in detention (CSDTAW, June 4–5, 1994).
levels to petty corruption. Exaggerated tales of grand corruption have been rampant in the last few years. Petty corruption has long been taken for granted, and even sympathetically tolerated.

Gallant but clumsy Egyptian security forces have had to confront growing numbers of Islamic militants, virtually on their own, for much of the last decade. They have been without supportive and politically mobilized public opinion. Two successive ministers of the interior (including the present incumbent) have repeatedly complained in the People’s Assembly of the lack of eyewitnesses ready to come forth and testify, even when acts of violence are committed in broad daylight in a marketplace (for example, the assassination of a police general and his drivers in Manfalout, Assuit, in 1993).

The situation seems to be slowly coming under control, however, thanks to strategic and tactical mistakes committed by the Islamic militants, the steady improvement of the capabilities of security forces, a growing (though reluctant) opening of “political dialogue” with opposition parties, and, most important, a recent uprising of Egypt’s civil society, especially the artistic community. For the first time in three years, the first half of 1994 witnessed a decline in the incidence of violence compared with the same period in the years since 1991. It is to be hoped that this will not lull the Mubarak regime into a premature sense of “victory” against Islamic militants or make it oblivious to badly needed sociopolitical reform.

The persistent vibrancy of Egypt’s Islamic activism is a cause for concern, but not for panic. Despite its marked problems, the Egyptian state remains relatively strong, and will no doubt prevail in the present armed confrontations with radical Islamic militants. The state possesses tremendous resources in this respect, most of which have barely been tapped: a political culture that values moderation, continuity, and stability; a potent civil society; a powerful media; a cohesive, loyal, professional army and internal security force; its own religious establishment; and its good regional and international relations.

The legitimate concern, not panic, is over the regime’s capacity to mobilize and manage these tremendous resources. So far, the regime has relied mainly on its security forces in confronting the Islamic extremists. Even with limited use of its resources, the Egyptian state is already turning the corner in this conflict. But the problem is not merely that of recording a “physical victory” over the Islamic extremists in the present round, but of dealing forcefully with the root causes that give rise to extremism, and to the deep alienation of Egypt’s civil society, without whose support ERSAP could easily be undermined. Here, it becomes imperative that the regime evolve a clear and comprehensive strategy of reform. Belatedly, the government is earmarking several LE billions for social upgrading of depressed areas in Upper Egypt and for creating about one-half million new jobs. Also belatedly, the regime has announced plans for a “national dialogue” with the long-neglected and marginalized opposition parties and professional associations. Had these two measures started a few years earlier, the regime’s governance capacity would have been greatly enhanced, and much of the violence may have been averted. Late as they may be, these and similar measures in the fields of education and the media illustrate the imperative of comprehensive reform—the social and the political along with the economic, and, better still, with an inspiring “vision.” Because the more difficult part of ERSAP is now under way, these two sociopolitical sides of the reform triangle are more needed than ever. The Mubarak regime could not go on much farther with ERSAP and “politics as usual.”

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44 Reference is to a series of antiterrorism television dramas and films that appeared earlier in 1994 and were well-received by the public.
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Successful Adjustment and Declining Governance? The Case of Egypt


The structural adjustment program in Ghana has been one of the most enduring programs in Africa, and it has been viewed as the model of success. It began as a stabilization program, and has evolved into an effort to change the development strategy of the country. Prior to 1983, Ghana, like most other African countries imbued with the dirigiste dogma of the 1960s and 1970s, pursued a state-led, import-substitution development strategy. In a thirty-one-country study, Ghana was classified as having the highest degree of price distortions (Agarwala 1983).

Within a decade Ghana has succeeded in dismantling and eliminating most of the controls and distortions in the economy, and it now boasts one of the most liberal trade and payments regimes with some of the lowest tariffs on international trade in Africa. Ghana now pursues an outward-oriented, export-led development strategy, with a reduced role for the state in directly productive economic activities.

Perceptions of the success of this program vary. To the international community, Ghana is a model of success. All the traditional indicators used to measure the success of economic reform—growth in GDP and exports, inflation, government budget deficits, and balance of payments—have shown improvement. Within Ghana, however, the assessment is mixed. Most Ghanaians will admit that the program has succeeded in removing the distortions in the economy and moving to market-based policy instruments. At the household level, however, the impact of the program is less visible. Agricultural production, the mainstay of the majority of the population, has lagged behind population growth. Cost recovery measures in health and education are biting hard.

In spite of these doubts, the program as a whole has brought substantial progress, even if the pace is slow. This is the first time that the Ghanaian economy has grown consistently for a decade, but the growth has been uneven. For the first six years of the program, real GDP growth was steady and averaged about 5 percent annually. Between 1990 and 1994 the growth rate decelerated, budgetary and balance of pay-
ments deficits reemerged, the rate of inflation increased, and the economy ran into unresolved difficulties. A number of fundamental questions are raised by this experience. Why has Ghana appeared to succeed where other African countries have failed, and reversed these policies? Even within Ghana, why has the program endured this time, when similar policies were tried between 1967 and 1971 and were reversed? Why did the program run into difficulties after six years? The difference could lie in governance capacity, where governance capacity is defined as the ability of the state to exercise power over society.¹

The objective of this study is to examine the relationship between governance and economic reform. The next section offers a brief review of the political economy of decline and successful reform. The first attempted reform of 1967–71 is then examined, followed by a look at the current program, starting from 1983. In the last section we draw together the evidence from the two economic reform experiences and offer some conclusions.

**Background to Economic Decline and Successful Reform**

Several reasons may be adduced to explain economic decline and the inability of governments to effect change. The new political economy theory identifies capture of the state by interest groups as a major reason for such failure. These interest groups have “a weight or influence that is disproportionate with reference to the economic gain that accrues to them” (Seabright 1994, p. 9). In some cases these interest groups were initially created by governments to provide support for their policies; they, in turn, captured the government. These interest groups became so entrenched that they gained the upper hand over rulers and blocked the implementation of appropriate economic policies (Frimpong-Ansah 1991). In the African context, Grindle concludes: “Relatively autonomous in their choice of policy at the outset, they [African leaders] soon become captives of the beneficiaries they have introduced and lose their capacity to alter policy” (quoted in Leith and Lofchie 1993, p. 245). There is a tendency for such a state to increase expenditures beyond the socially optimum levels; it then becomes revenue-starved.

According to Leith and Lofchie (1993), the Ghanaian postindependence policy regime both rewarded urban interest groups and led to their growth. Urban interest groups thus became powerful forces in the maintenance of these policies. Both Frimpong-Ansah (1991) and Leith and Lofchie (1993) identify the interest groups, and thus the beneficiaries of these policies, as the politicians, urban classes, workers and managers of the protected state industries, traders, the military, and bureaucrats.

Why were the losers, primarily small-scale farmers, unable to lobby for appropriate policies? According to the theory of collective action, this may be because of the small size of their holdings, the large number of farmers, their geographical distribution, and the cost of organizing. When a market contains many small agents, and therefore large fixed costs of organizing, the benefits that each can realize by securing appropriate policies may not exceed the costs of lobbying. Rational behavior may thus lead the members of this group to seek a free ride, and there is little incentive to engage in collective action (Bates 1990). Government’s ability to offer selective incentives enables it to reward those who conform and punish those who do not. According to Leith and Lofchie, selective incentives were also used to

¹ For definitions of governance see Boeninger 1991 and Landell-Mills and Serageldin 1991.
buy-off large-scale farmers. The supply of inputs and equipment to large-scale farmers at subsidized prices reduced their incentive to organize the other farmers.

When the exploitation of these groups has gone to extremes, the losers from the policies of the ruling elite exit from the economic system through parallel markets, smuggling, and movement toward subsistence production. The rents then disappear, and the cost of inappropriate policies are passed back to the ruling coalition. The response of the peasant farmers by the late 1970s—particularly cocoa farmers—was to exit from the economic system through the parallel market. For Lal (1987), economic reform is an attempt by the state to regain control of such an economy.

Reforming the economic situation described above requires conviction in favor of radical economic reform and the desire to bring about fundamental change in the ideological underpinnings of domestic politics (Frimpong-Ansah 1991). This requires both political and economic resources. Political leadership is needed to form coalitions or create associations to tackle social problems. The just exercise of authority, a capacity for problem solving and conflict resolution, and the efficient performance of its functions based on the involvement of a societal coalition are important in Boeninger’s (1991) conception of such good government.

All economic reform involves winners and losers. It encompasses changes in the distribution of gains and losses in society. The creation of a vision that will bring about a change in the distribution of interests in such a way that the gaining group is able to compensate the losers, and everyone will be better-off, may be important. If such a vision is perceived as a positive influence for all groups, and not for just one sector of society, it will promote voluntary compliance and commitment. Support can be marshalled for that vision if it is well articulated, if a new support group is developed to counterbalance detractors by indicating clearly whom the potential winners will be, and if the previous set of economic policies can be proven not to have served the interests of all.

Given the presence of a vision, success will depend on implementation capacity, which requires adequate human resources for analysis, planning, and implementation, as well as institutions able to meet the requirements of the new policy environment. Major institutional reforms and innovations may be required in some cases; in others, minimal institutional reforms and motivation may be all that is needed. Whatever the surrounding conditions, implementation capacity requires financial resources.

For a captured state that is also revenue-starved, an immediate increase in government revenues is essential for institution building. Increased revenues are also crucial to the provision of a credible system of incentives to motivate appropriate behavior and reduce dependence on rents.

The First Reform Episode, 1966–71

**Initial Conditions**

The first attempt at economic reform took place between 1966 and 1971. It was initiated by a military regime that handed over power to a constitutionally elected government in 1969. The military government, the National Liberation Council (NLC) had considered its tenure temporary from the start.

The NLC government inherited a heavily controlled economy in decline, with high budgetary deficits and inflation. The balance of payments situation was critical, reserves had run down, and
there was a general shortage of goods and services (as will be seen later, these conditions were nothing compared with the devastation of the economy inherited by the time of the structural adjustment program in 1983).

The development strategy adopted by Ghana in the immediate postindependence period was based on state-led import-substitution. The vision was the eventual establishment of an industrial socialist state. Starting with the initiation of the five-year development plan in 1959, there were massive increases in government expenditures to create both the physical and human capital required to attain this objective. These investments were high in import content and brought about a deterioration in the balance of payments. At the initial stages, both the resulting budgetary and external payments deficits were financed by running down the huge external reserves that Ghana inherited at the time of independence.

With the foreign exchange reserves declining sharply and the budget deficits rising rapidly, the government resorted to a series of strong measures. Taxes were raised and exchange controls introduced in July 1961, and by December 1961 comprehensive import licensing was introduced.

In spite of the deteriorating external payments and fiscal deficit, a more ambitious development plan was launched in 1963-64 to boost the import-substitution industrialization process. Both trade and payments controls were intensified, and the government refused to use the exchange rate as a policy instrument.

The result of these policies was that in spite of the high rates of investment—principally public investment—the growth performance of the economy declined. In the immediate postindependence period (1957-61), when the liberal trade regime was maintained, real GDP grew at an annual average rate of about 5 percent. With the introduction of the controls following the big push, GDP growth slumped by more than half. Between 1962 and 1966 the real GDP growth decelerated to an annual average of 2.4 percent.

The annual rate of inflation increased from an average of 6 percent between 1961 and 1963, to 16 percent in 1964, and 23 percent in 1965. With increasing inflation and a fixed nominal exchange rate, the real exchange rate appreciated and the currency became overvalued. Frimpong-Ansah (1991) estimates that the currency was overvalued by 7 percent in 1963. By 1965 the overvaluation had increased to 45 percent, and to 60 percent in 1966. This overvaluation of the currency, combined with the taxation of exports implied by the restrictive regime, caused the external payments situation to deteriorate. The current account deficit increased from $33.7 million in 1962 to $222.9 million in 1965.

The main sources of government revenues were cocoa and imports. The cocoa tax base declined from 16 percent of GDP in 1958, to 9.2 percent in 1965, and 7.7 percent in 1966. The import tax base declined from 35 percent in 1961 to 22.9 percent in 1964; it then increased to 26.7 percent in 1965, but declined to about 20 percent in 1966.

As a result, government revenue as a percentage of GDP stagnated at around 14 percent between 1961 and 1963. It increased to 18.7 percent and 19 percent in 1964 and 1965, respectively, but declined to 15 percent in 1966. While the revenue base declined, expenditures increased throughout the period, which led to severe budget deficits that fueled inflation.

The Program

The economic situation gave rise to popular dissatisfaction. Combined with political repression, this led to a military coup that overthrew the Nkrumah government in February 1966 and the formation of the National Liberation Council (NLC) government. The military government immediately set about consulting chiefs and the opposition leaders to gain insight into how to tackle the economic problems of the country. This could be interpreted as an attempt to shift the base of the ruling coalition.
While these groups were important, the more politically active were the urban workers who benefited from the controls. The immediate economic hardships of the latter part of the Nkrumah regime must have turned urban workers against him, but his socialist policies created a sense of nationalism. Reconciling nationalism based on state-led industrialization and controls with the immediate needs of the economy was the major problem confronting the military government. Its approach was to portray itself as transitional, playing only a stabilization role. This presentation, however, did not resolve the problem of Ghanaian attachment to Nkrumah's ideals. The government recognized the need to break this attachment. It set up a civil education department, led by Professor Busia, a Ghanaian sociologist, to do this, but it failed. It seemed that the NLC itself was attached to these ideals and that its commitment to liberalize was only “skin-deep.” As Killick (1978, p. 301) put it, “In fact, one suspects that the NLC’s public commitment to complete liberalization was intended chiefly to mollify the IMF and aid donors.”

Without an alternative vision to rally support for its program, the NLC had to be sensitive to worker reaction to the immediate hardship it would impose. This sensitivity implied that when it had to choose between reducing real wages and cutting back on capital expenditures, the NLC chose to cut back capital expenditures, while increasing nominal wages. It could not close down inefficient state enterprises, and controls remained in place throughout.

The NLC was content to leave the actual management of the economy to civil servants and other professionals led by Omaboe, a former government statistician under the Nkrumah regime. “It set out to restore ‘efficiency’ to the economy and was not much concerned with the elaboration of a coherent body of economic ideas” (Killick 1978, p. 54).

Under the auspices of the National Economic Committee, the main problems of the country at the time of the coup were identified as the following (Killick 1978, p. 55).

1. correction of the present imbalance in the country’s foreign payments position
2. arrest the inflationary pressures to which the economy had been subjected during the past few years
3. provision of more job openings for the growing population
4. the restoration of balance to the government’s budget.

The government’s overall strategy for dealing with these issues, together with the advice of the IMF, led to the pursuit of orthodox disinflationary fiscal and monetary policies. At the same time, the government sought to avoid adverse effects on production by improving capacity utilization and preparing the economy for another development effort to be launched as soon as stabilization had been achieved.

In pursuit of this strategy, a number of measures were undertaken. First, government expenditures were cut from C361.1 million in 1965 to C268.9 million in 1966 to reduce demand pressures on prices and the balance of payments. The NLC did not put much emphasis on improving the fiscal balance by increased taxation. It was thought that a substantial increase in the tax effort had already been achieved in the preceding years. Second, a program of liberalization intended to eventually abolish import, price, and exchange controls was implemented. Emphasis was placed on the role of private enterprises. A few state enterprises were sold to private investors, some state farms were closed down, and the Ghana Industrial Holding Corporation (GIHOC) was formed to improve the economic performance of the remaining state enterprises. The currency was devalued in July 1967 as part of a package to obtain external assistance.
The NLC economic program was, in general, an attempt to stabilize the economy and create an atmosphere conducive to private investment. But before the soldiers left office, they began to worry about the effects of their stabilization policies, as expressed in the subheading of the development plan they prepared, "From Stabilization to Development."

The NLC kept its promise to hand over power to an elected government. It organized elections on the Western model, which were won by the Progress Party (PP), led by Professor Busia. While committing itself to continue with the reform program, the civilian administration that took over from the NLC government nevertheless came into power without an economic program.

What economic policies could be identified in the PP’s discourse were not credible in view of their ambiguities. In the words of Killick (1978, p. 56), “In spite of an apparently positive attitude to the freer operation of market forces, a large role was also envisaged for the state—an ambiguity neatly illustrated by the co-existence on the same page of pledges to move away from trade controls and to improve the enforcement of price controls.”

The elections did not give the government enough political power to continue the economic reforms begun in 1966 with the same authority the NLC had demonstrated, despite its parliamentary majority. The two parties that contested the elections were ethnically based. The Convention Peoples Party was proscribed, and its members refused to join other parties. The 1969 elections thus did not generate adequate political competition. As Afrifa, one of the leaders of the 1966 coup was to indicate later, “the irony of the present situation in Ghana is that it is quite possible that President Nkrumah and the CPP would command the support of a majority of the electorate... in genuinely free elections... Busia as leader of government was, in political economy terms, at the centre of an essentially Nkrumahist state that he did not identify with, and therefore could not control” (quoted in Frimpong-Ansah 1991, p. 100).

The government’s support base was rural, while most of the urban masses, created by the policies of the Nkrumah era, were Nkrumahist. Busia needed mass support for his program. He favored a shift of resources to the rural areas, but with limited financial resources, he could not do this without adversely affecting the welfare of the urban masses. He had to pay attention to these urban pressure groups, even though he could not incorporate them into his power base.

Growth was to be achieved through an increase in government expenditures in line with Nkrumah’s strategy. The growth strategy began during a period of increasing world cocoa prices and rising terms of trade. There was increasing dependence on external financial resources to finance the budget. Revenues were buoyant, primarily because of the increase in cocoa prices.

Response of the Economy to Reform

As a stabilization measure, the program was successful even though the expected balanced budget was not achieved. The overall budget deficit as a percentage of GDP generally declined between 1967 and 1970 compared with the preprogram period (tables 1 and 2). From a high of 8.8 percent in 1966, the budget deficit/GDP ratio declined to about 3 percent in 1970, although there was a slight increase in 1968.

Expenditure targets were met in the first two years by restraining development expenditures to meet recurrent expenditure considerations. To placate urban workers, wages and salaries were increased. As a share of total recurrent expenditures, worker compensation rose from 28.5 percent in 1965 to 34.6 percent in 1968 (Central Bureau of Statistics 1976). It rose by 83 percent between 1966 and 1969, while total recurrent expenditures rose by 54 percent over the same period. Development expenditures rose rapidly during 1969/70. Central government spending on new capital goods declined in 1967, and again
Table 1

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<td>429.3</td>
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<td>89.4</td>
<td>104.6</td>
<td>122.6</td>
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<td>Recurrent</td>
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<td>303.8</td>
<td>324.7</td>
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<td>2.3</td>
<td>18.5</td>
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<tr>
<td>Expenditures</td>
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<td>382.4</td>
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<td>488.4</td>
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<td>317.1</td>
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<td>Revenue</td>
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<td>300.2</td>
<td>291.2</td>
<td>369.2</td>
<td>501.4</td>
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<td>Current account surplus/deficit</td>
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<td>-25.2</td>
<td>-4.5</td>
<td>123.2</td>
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<td>Overall surplus/deficit</td>
<td>-60.8</td>
<td>-70.3</td>
<td>-91.3</td>
<td>-88.4</td>
<td>13.0</td>
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Table 2

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<td>Overall budget/GDP ratio</td>
<td>7.7</td>
<td>8.8</td>
<td>5.3</td>
<td>7.6</td>
<td>3.8</td>
<td>3.3</td>
<td>5.6</td>
<td>5.7</td>
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<td>Share of domestic credit</td>
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<tr>
<td>Central government</td>
<td>51.1</td>
<td>50.4</td>
<td>55.3</td>
<td>58.6</td>
<td>54.2</td>
<td>48.5</td>
<td>39.2</td>
<td>43.2</td>
</tr>
<tr>
<td>Other government</td>
<td>12.9</td>
<td>18.1</td>
<td>9.7</td>
<td>12.9</td>
<td>12.9</td>
<td>19.1</td>
<td>16.3</td>
<td>20.2</td>
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<tr>
<td>Change in credit to central government</td>
<td>45.9</td>
<td>15.1</td>
<td>29.7</td>
<td>18.4</td>
<td>-0.6</td>
<td>-7.0</td>
<td>-0.7</td>
<td>23.8</td>
</tr>
<tr>
<td>Inflation</td>
<td>34.9</td>
<td>11.7</td>
<td>-9.0</td>
<td>8.8</td>
<td>7.1</td>
<td>3.7</td>
<td>9.3</td>
<td>10.0</td>
</tr>
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</table>


in 1969. As table 2 indicates, a decline in the rate of inflation was achieved. From a high level of 34 percent in 1965, the rate declined continuously to about 3 percent in 1970, but it rose to about 9 percent in 1971.

The constraints on aggregate demand expansion and the import licensing system that was still in place ensured a decline in the volume of imports in 1966 and a considerable reduction in the current account deficit (table 3). The devaluation of the cedi in 1967 had a further dampening effect on the demand for imports, with import volumes declining by 6 percent.

To ameliorate the impact of the devaluation of the currency, customs duties and some sales taxes were reduced or removed, and the export duty on diamonds was removed. Adjustments were made to the income tax regulations to re-
duce the burden of the devaluation for some companies. These measures caused a decline in import duties between 1966 and 1969, thus partially explaining the inability to achieve revenue targets. The net effect of the tax measures accompanying the devaluation was to reduce the average import tariff rate from 30.8 percent in 1966 to 25.8 percent in 1967 (Leith 1974). The cocoa tax rate declined between 1966 and 1967, but rose in 1968. The average export tax rate fell between 1966 and 1968. The effective exchange rate for imports thus rose by some 36 percent between 1966 and 1967, while the effective exchange rate for exports rose by 84 percent. The bias in the trade regime, however, persisted.

The current account deficit and the current account–GDP ratio fell continuously until 1970, largely because of the rising commodity terms of trade, the constraint on domestic aggregate demand, suspension of interest payment on suppliers’ credit in the 1966/67 budget, and subsequent rescheduling of loans. Export performance, however, was disappointing. Export volumes were below their 1966 levels at the end of the stabilization period. An export promotion package was introduced in 1969 to encourage nontraditional exports in particular, but was not implemented until 1971. The shortcomings of the trade regime during the stabilization period persisted, and explain the poor performance of the export sector.

Not much progress was achieved in divesting the state of productive enterprises. Of twenty enterprises that were listed for divestiture in 1967, seven were put up for outright sale. The NLC government succeeded in having only one outright sale, and transferred two state-owned enterprises into joint ventureships. No headway was made in the divestiture of state enterprises, and by the end of 1971 five new state enterprises had been created. Although the results of this effort were encouraging in the reduction of the external deficit, urban unrest increased because of growing unemployment, reduced real incomes, and declining expenditures on education and health (Stryker 1990). Both the balance of payments and budgetary situations remained precarious, but were masked by rising cocoa prices. Table 3 illustrates the improvement in the terms of trade from 1967 to 1970.

In 1971, when world cocoa prices dropped sharply, and the government envisaged a large budget deficit for 1971/72, it devalued the currency by 44 percent, cut government expenditures, and increased taxes. Prices of most consumer items increased substantially. The resulting urban unrest provided justification for a military coup led by Colonel Acheampong in January 1972. The immediate action of the new government, the National Redemption Council (NRC), was to partially revalue the currency and reintroduce controls.

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**Table 3**

**The External Account, 1965–71**

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<tr>
<td>Trade balance (US$ million)</td>
<td>−118.2</td>
<td>−40.4</td>
<td>18.8</td>
<td>39.8</td>
<td>49.7</td>
<td>51.9</td>
<td>−33.6</td>
</tr>
<tr>
<td>Current account (US$ million)</td>
<td>−222.9</td>
<td>−127.8</td>
<td>−84.9</td>
<td>−56.1</td>
<td>−60.1</td>
<td>−67.7</td>
<td>−145.8</td>
</tr>
<tr>
<td>Current account deficit/GDP ratio (percent)</td>
<td>10.8</td>
<td>6.1</td>
<td>4.9</td>
<td>3.4</td>
<td>2.9</td>
<td>3.1</td>
<td>6.0</td>
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<tr>
<td>Percent change in export volumes</td>
<td>2.5</td>
<td>−15.7</td>
<td>−8.6</td>
<td>2.3</td>
<td>−17.3</td>
<td>10.9</td>
<td>−29.7</td>
</tr>
<tr>
<td>Percent change in import volumes</td>
<td>27.3</td>
<td>−11.4</td>
<td>−5.9</td>
<td>32.5</td>
<td>−6.5</td>
<td>9.5</td>
<td>−16.0</td>
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<tr>
<td>Commodity terms of trade (1975 = 100)</td>
<td>76.0</td>
<td>75.0</td>
<td>89.0</td>
<td>93.0</td>
<td>111.0</td>
<td>121.0</td>
<td>91.0</td>
</tr>
</tbody>
</table>

Explaining What Happened

This first attempt at economic reform failed because of a number of interrelated governance issues, including the failure to articulate an alternate and credible economic vision, capture by interest groups, weakness of the leadership, and inconsistent policies.

There was a failure to articulate an alternate vision to replace Nkrumah’s, and it was thus difficult to make a dramatic shift from previous policies. The NLC government presented itself as temporary, in power only to perform a stabilization role. It therefore probably did not consider the need for the creation of a different strategy. The new civilian government that took over in 1969 suffered from the same disadvantage. According to Killick, “Busia and his colleagues came to office with little by way of an economic policy. It was, as those advising them quickly discovered, impossible to derive from the election manifesto the Progress Party a meaningful economic program” (Killick 1978, p. 56).

Because of this lack of an alternate economic policy strategy, no new interest groups emerged that exhibited support for the policies. The potential losers from the new economic strategy were therefore more likely to exert significant pressure on government and achieve their objectives.

Both the NLC and the Busia administration succumbed to pressure and were captured by interest groups. It would appear that both governments succumbed to labor demands to increase wages to reduce the possibility of unrest. Wage and salary increases were provided to some public sector employees in the July 1967 budget statement to “alleviate the immediate hardships due to the . . . devaluation of the currency” (Ghana 1968, p. 4). An indication of the lack of autonomy of the government was the growth in the share of compensation of employees as a proportion of recurrent expenditures. By 1971 this line item was about 45 percent of recurrent expenditures, rising from 34 percent in 1968. Wages and employment were used as a ploy to get the support of the vocal urban workers, a group that gave the government little support.

In the 1969/70 budget statement, expenditure cuts, including a ban on spending on minor capital items, was to be imposed because of “the relatively large share of personnel emoluments in the total recurrent budget . . . and a decision not to reduce the army of government employees by any substantial numbers” (Ghana 1969, p. 23). A re-deployment program was put in place at the same time that expenditures were to be constrained. In 1968, public sector employment expanded by 10 percent, despite the policy of retrenchment.

Both governments sought to control the leadership of the Trade Union Congress (TUC), but failed. This led to several incidents of unrest in the 1967–71 period, and the Busia regime dissolved the TUC in September 1971. An examination of the number of disputes by sector between 1968 and 1971 reveals that they increased during this period, with an escalation in 1971 (see figure 1). The trade unions and their management had formed lobbies to resist some of the government measures, and this may explain the failure of the divestiture program, as well as the skewed nature of the cuts in central government spending. There was a lack of state autonomy, with private interests able to influence government policies. One reason the import surcharge scheme introduced by the Busia administration was not as effective as it should have been was because “the tax effort was far lower than would have been required to make the liberalization viable and protect the balance of payments in the circumstances of an overvalued currency” (Ofori-Atta 1975, p. 18). This was explained by a deputy minister of finance of the Busia administration: “when succumbing to political pressures, the government exempted a number of importers from surcharges and granted stretch-out payment terms to others” (Ofori-Atta 1975, p. 18).

Another reason for the failure of the economic reform program was the weakness of the Busia
government. The regime was unsure of how to respond. An assessment of the structure of the Busia government by the governor of the Bank of Ghana notes that Busia was "running his cabinet more like a college tutorial. Decisions were based on careful study and lengthy arguments. Individual members who were eloquent or persuasive tended to create and develop their own lines of thought and action which were not necessarily those of the Cabinet, the Party or the Prime Minister" (Frimpong-Ansah 1991, p. 100). Libby's (1976) discussion of the decisionmaking process leading up to the December 1971 devaluation shows that there was a contest within the cabinet for the control of economic policy. The conflicts within government and the indecisiveness of the prime minister resulted in a sluggish response to the crisis as it emerged. These conflicts were accentuated because some members of the cabinet were of the Nkrumahist tradition. This may explain the lack of an articulate strategy with clear objectives that were different from Nkrumahist ideas.

The reform process was also reversed because the import liberalization component had become macroincompatible. Import liberalization had begun cautiously with a gradual relaxation of quantitative restrictions and a reduction of import duties on selected goods. As it progressed, it had to be supported by a currency devaluation, an increase in indirect taxes, or a slowdown in the growth of the money supply to ensure that the balance of payments would not deteriorate. Unfortunately, the required devaluation did not occur until December 1971. Restraints on the growth of the money supply were relaxed in 1969. Concern about generating the support of the urban workers and capture by some interest groups reduced the effectiveness of the import surcharge scheme introduced in lieu of devaluation. The policy inconsistency of the program is evident in the increase in the size of the current account deficit in 1970 (table 3). Short-term debts increased by $79.2 million between September 1969 and June 1971 (Frimpong-Ansah 1991, p. 105). There was no effective export promotion package to counteract the effect of the import control system still in place, despite the liberalization of imports and the appreciation of the real exchange rate. The improve-
ment in cocoa prices as the import liberalization program progressed initially masked the domestic policy inconsistencies.

Busia’s economic program was dependent on aid flows that did not materialize to finance the excess of government expenditures above domestic revenues. The 1969/70 budget included expected external budgetary support of C55 million, but only C39 million was achieved. A similar shortfall occurred in the 1970/71 financial year, when only C37.2 million of the expected C50 million was received. It has been estimated that gross total assistance (that is, debt relief, net credit from the IMF, and long-term aid receipts) declined between 1969 and 1971 (Killick 1978). At the same time, import revenues had fallen continuously between 1966 and 1969. In 1969 they stood at C82.8 million, compared with C111.2 million in 1966. The increase in the import surcharges in 1970 reversed the decline.

Policymakers failed to realize that since export performance was poor and external aid flows generally fell below requirements, there was a need to slow down the import liberalization process, restrain expenditures, and possibly change the growth strategy to encourage increased private investment through an improved incentive structure. The decline in cocoa prices exposed the weakness of a strategy that depended on increasing government expenditures and a buoyancy in the revenue base that depended on artificially high cocoa prices.

The Current Reform Program: 1983 to the Present

The Deterioration of the Economy Prior to Reform

Acheampong, the leader of the military government that overthrew the Busia administration, set out what was to be the guiding principle of economic policy in an address to the Ministry of Finance and Economic Planning (quoted in Killick 1978, p. 299): “The political frame of reference which has guided your actions and your advice especially in the last two years must be cast into the rubbish heap of history. This means a departure from the ‘laissez-faire’ so called free market economy and the institution of effective planning in the allocation and utilization of resources.”

Whether laissez-faire or a free market economy represented the correct interpretation of the Busia period or not, this statement implied a rejection of the previous policies. The government partially revalued the currency and unilaterally repudiated some of Ghana’s debts. Comprehensive import and payment controls were reintroduced, and the scope and coverage of price controls were widened. The overall principle of government was self-reliance and a reduction in dependence on external resources. Economic policy had moved full circle to the command economy of the Nkrumah era. Except for brief periods between 1979 and 1980, when some attempt was made at liberalizing the trade regime with a devaluation of the cedi in 1978, these controls remained in place up to 1983.

As these policies began to take effect, the rate of inflation almost tripled within four years, from 11 percent in 1972 to 30 percent in 1975 (table 4). The real depreciation in the currency achieved with the devaluation of 1971 began to erode. In subsequent years the currency appreciated sharply. The index of the real effective exchange rate increased continuously from 22 in 1972, to 46 in 1976, and 278 by 1982. The ratio of the parallel

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2 For full details of economic policies during this period see Jebuni, Oduro, and Tutu 1994 or Rimmer 1992.

3 See Jebuni, Oduro, and Tutu 1994. The index is calculated in such a way that an increase indicates appreciation.
Table 4

Selected Economic Indicators, 1970–83

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<tr>
<td>Export volume index (1980=100)</td>
<td>220.9</td>
<td>155.2</td>
<td>186.6</td>
<td>169.2</td>
<td>139.5</td>
<td>142.8</td>
<td>149.7</td>
<td>123.3</td>
<td>101.6</td>
<td>96.8</td>
<td>100.0</td>
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<td>128.8</td>
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<td>100.0</td>
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<td>1.15</td>
<td>1.15</td>
<td>1.15</td>
<td>2.75</td>
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<td>2.75</td>
<td>2.75</td>
<td>30.00</td>
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<td>1.3</td>
<td>1.3</td>
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<td>5.8</td>
<td>9.5</td>
<td>22.4</td>
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</table>

a. Net credit to the central government by the banking system, billions of cedis.
b. Credit to the nonfinancial public institutions by the banking system, billions of cedis.
c. End of period.
d. October 1983.


With the highly overvalued exchange rate discouraging exports, the intensification of controls worsened the situation. In spite of the highly favorable terms of trade between 1972 and 1979, both import and export volumes declined (table 4). Exports as a proportion of GNP decreased from 20 percent in 1972, to 10.5 percent in 1977, and 3.3 percent in 1982. The proportion for imports followed a similar pattern, declining from 13.5 percent in 1972, to 10 percent in 1977, and to 2.5 percent in 1982. Even though trade and exchange controls were intensified to contain the adverse balance of payments effects, by 1981 the current account deficit before official transfers stood at $508 million.

With an expanded role for the state government, expenditures increased. To finance these expenditures the government instituted high excise duties, export taxes, import duties, and an array of complex income and profit taxes. Nevertheless, with the general controls and overvalued exchange rate, both rent-seeking activities and parallel markets in commodities and currency developed. The official economy shrank, and with it government revenues. The tax base on both imports and exports declined sharply, and tax compliance decreased. Government revenues as
a proportion of GDP declined throughout 1975-83, from 15.5 percent in 1975 to 5.6 percent in 1982 (Frimpong-Ansah 1991, p. 160). Although occasional attempts were made to cut expenditures, they remained high, largely because of recurrent expenditures. One lesson most Ghanaian governments had learned was that political success depended on the ability to minimize the discontent of the politically active urban classes. As the rate of inflation accelerated and the control system failed to supply commodities either in sufficient quantities or at controlled prices, urban unrest developed. To placate these groups, beginning in 1975 the government increased borrowing from the banking system to finance expenditures. Government spending had no relationship to budgetary plans. For the 1976/77 fiscal year, the original estimated deficit on the current account of the budget was about C20 million, but the year ended with a deficit of C233 million. In 1977/78 a surplus was originally envisaged, but the government incurred a huge deficit of C1.119 billion. Against the large surplus of C287 million planned for 1978/79, a deficit of C346 million was incurred. The resulting deficits and the underlying trend in components of government expenditures are captured by the Economic Survey of 1980. “Even though the deficits were incurred on account of large increases in expenditures by the government an overwhelming proportion of the increases were on account of recurrent expenditures; development expenditures moved up slowly and far behind the rate of inflation. Thus investment in the government sector in real terms recorded a declining trend” (Central Bureau of Statistics 1980, p. 22).

The situation was made more difficult because the government budget did not cover expenditures by state-owned enterprises, which generally were funded by “below the line” items. Although it was expected that the budgets for these enterprises would be submitted to the Ministry of Finance and Economic Planning for approval, according to Ministry sources this was not done. Data to assess expenditures by these enterprises, and thus total public expenditure, were generally unavailable because they did not keep records. Nonetheless, some indication of their effects on expenditure control can be obtained by looking at their sources of funding. The first source was direct subvention from the below-the-line item of the budget. The extent of this funding depended on the minister or commissioner of state, and the relationship between the managing director of the enterprise and the minister. A second source was internal borrowing from the banking system. This was done directly by the enterprises themselves, by instructions from ministers to banks to lend to these enterprises, or by government acquisition of loans on behalf of the enterprises. The third source was external borrowing by the state enterprises and the receipt of plant and machinery donated by foreign governments, particularly governments of the former Eastern Bloc. The final source of funding was the capitalization of the tax, dividend, and Social Security funds of workers. Some indication of financing may be found through an examination of bank credit to nonfinancial public institutions. According to the monetary survey, credit to these enterprises increased from C115 million in 1970 to a peak of C6 billion in 1982 (table 4).

Thus, by the start of the structural adjustment program Ghana had experienced a continuous decline in growth of GDP since 1975 as a result of these policies. In every year after this period, except for 1977 and 1978, real GDP declined. The external position of the economy was precarious. Gross external reserves as a ratio of GDP stood at 0.7 percent by 1982.

The deterioration in economic conditions created fertile ground for another military intervention. On 31 December 1981, the government was overthrown by a military coup led by Flight-Lieutenant Rawlings, who formed the
Provisional National Defence Council (PNDC) to rule the country.

The Decision to Change

It is unclear when the commitment to change occurred within the PNDC. What is clear is that the PNDC did not come to power with a program of economic reform based on a market system. If they had a vision, it was based on the notion that the economic woes of the country were the result of exploitation of the masses and the corruption of the system—essentially a socialist philosophy. Both Frimpong-Ansah (1991) and Leith and Lofchie (1993) argue that the fundamental reason for the change in direction by the PNDC was the failure of its original philosophy and the increasing threat to the survival of the nation arising from the policies—or lack of policies—associated with this philosophy.

During its fifteen months in power, from January 1982 to March 1983, the PNDC government adopted a radical populist approach to economic recovery. The objective was to create a democratic society free of corruption and inequality. The majority opinion among government functionaries favored attempts to rid the country of corruption and stamp out smuggling. The strategy was to implement a Libyan-style revolution, while relying on domestic resources. Where external assistance was required, this was to be obtained from Libya or the friends of Africa, essentially the former USSR and Eastern Bloc countries. These measures had disastrous consequences for the economy and society. The economic situation deteriorated sharply, government revenues plummeted, and the authority and governance capacity of the state diminished. There was no improvement in the tax base, because parallel market activities continued and estimated output declined. Opposition to the government grew with the worsening economic conditions. There were two coup attempts in 1982, and several groups registered their protests against the government—TUC, Christian Council, Ghana Bar Association, and groups on the political left. Visible signs of suffering, social chaos, and political disintegration were everywhere. These developments, combined with the limited assistance from Libya compared with the capital requirements for reform and the negligible prospects of substantial assistance from the Eastern Bloc donors, must have convinced some members of the PNDC of the need for change.

A second fundamental reason for change was prior adjustment. One of the crucial elements in reform programs that had held back most Ghanaian governments was the devaluation component. Possible inflation and the resulting political turmoil were the main concerns. This is why the Nkrumah government rejected the IMF package in 1965. The Busia regime was concerned about its political base, and when it did eventually devalue the currency, it was overthrown. By 1983, however, the booming parallel market had pushed most prices to a level that reflected the scarcity value of foreign exchange. With virtually no supplies flowing through official channels, most Ghanaians adjusted to the prices. In these circumstances a devaluation would not affect domestic prices of importables. Thus, in the short run it could be expected that domestic prices would not be affected by the devaluation. This de facto price adjustment would imply that official prices would be adjusting toward what Ghanaians already paid.

In addition to this prior price adjustment, the rents that held the ruling coalition together had disappeared as the groups that generated the rents, the cocoa farmers and small-scale farmers, exited from the formal economic system through parallel markets and smuggling. According to Leith and Lofchie, the extraction of rents had gone beyond the optimum. This explains why the PNDC could

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4 This was despite the actions of the regime in coming to power by overthrowing a democratically elected government.
expect that social groups that ordinarily would have opposed the reforms would probably not do so now. For the urban sector, much of the suffering and deprivation associated with economic decline had already taken place. Urban wage earners had suffered a decline in real incomes as inflation outpaced the increases in wages.

Moreover, the main organized opposition outside the government believed in the need to devalue the currency and liberalize the system. The government of the Third Republic that was overthrown by Flight-Lieutenant Rawlings had actually agreed to an IMF program of reform involving a devaluation, demonetization, and liberalization of the system. The minister of finance and economic planning was expected to travel to Washington, D.C., in 1982 to sign the agreement. The other main organized political group included members of the government that had attempted the first reform. They still believed in the kind of reform measures that were to be undertaken in 1983. If there was opposition, it was to the extent and degree of the reform program.

The main obstacle to change was within the PNDC government itself. The left wing of the government was opposed to discussion of market-based policy and involvement of the IMF and World Bank. The dilemma within the government was summarized by Kwesi Botchwey, Secretary for Finance and Economic Planning (quoted in Callaghy 1989, p. 115).

We were faced with two options, which we debated very fiercely before we finally chose this path. I know because I participated very actively in these debates. Two choices: We had to maneuver our way around the naiveties of leftism, which has a sort of disdain for any talk of financial discipline, which seeks refuge in some vague concept of structuralism in which everything doable is possible. ... Moreover, we had to find a way between this naiveté and the crudities and rigidities and dogma of monetarism, which behaves as if once you set the monetary incentives everybody will do the right thing and the market will be perfect.

A third reason was the realization by the leadership—as demonstrated by a group of Ghanaian professional economists led by Dr. Abbey—that the source of the economic problem was the overvaluation of the currency and the producer price of cocoa. It was recognized that the correction of these distortions would be beneficial to the well-being of the cocoa farmer and would reduce rents going to the corrupt (Leith and Lofchie 1993). The exchange rate and cocoa price policy were interlinked, because the ability to increase the producer price of cocoa without compromising cocoa revenues was dependent on a devaluation of the cedi. It was a mark of the strength of the leadership of the PNDC that unlike those in office during the previous reform attempt, it was not paralyzed by internal debate.

When the leadership was convinced of the need to adopt market-based reform policies, it made the decision. Given that the PNDC had come to power to reform a system it believed was corrupted by the exploitation of capitalists, it is doubtful that its attitude toward the private sector could change. For the private sector the philosophy of the PNDC prior to the reform program created doubts about its commitment to market reform. The debate, the struggle for power, and attempts to overthrow the government forced the PNDC into a security-centered policymaking process that did not allow wider national debate or participation. As will be discussed later, this approach led to exclusion of the bureaucracy from policy formulation.

The Reform Program

There were three immediate requirements for reforming the Ghanaian economy in 1983. First, it was essential to reduce the rate of inflation from the three-digit level to a reasonable rate. Second, there was a need to increase production, particularly of traditional exports, both as an input into reducing the balance of payments deficit and reducing inflation. Finally, it was critical to increase government revenues sharply. As discussed ear-
lier, the previous policies had depleted government revenues, and increased revenues were essential for the restoration of the state's governance capacity.

In addressing these immediate concerns, and extending through almost all of the adjustment period, the strategy was to address simultaneously both issues of policy design and implementation. Not only would the policy initiative require institutional changes, but also arrangements aimed at addressing the issue of adequate compensation or incentives to induce the relevant response at each stage.

**Trade and Exchange Rate Reform**

Fear of the political consequences of an outright nominal devaluation delayed the government’s use of this instrument to correct the exchange overvaluation. Instead, a multiple exchange rate system was introduced. The nominal exchange rate remained fixed at its 1978 level, but a system of surcharges and bonuses was introduced that increased the actual exchange rate. As a result of the system of surcharges and bonuses, traditional exports and imports of crude oil, essential raw materials, basic foodstuffs, and capital goods were subject to an actual rate of C23.75 to the U.S. dollar. Nontraditional exports and other imports faced a rate of C25.975 to the U.S. dollar. The exchange rate was unified in October 1983 to C30 to the U.S. dollar. These policy measures were then followed within the same year by fiscal retrenchment and disinflationary monetary policies.

While these macroeconomic policy initiatives were taking place, and providing the relevant incentives for production, government also took measures to remove the immediate supply constraints to the traditional export sector. Roads and railways to cocoa, timber, and mineral producing areas were rehabilitated. Foreign loans were lent to timber and mineral producers.

Having achieved a certain level of stabilization in the initial years, the program moved to address microeconomic distortions. Significant changes in trade and exchange rate policy have been undertaken since 1983. Following the initial unification of the exchange rate, incentives were maintained through periodic devaluations of the exchange rate. These announcements became increasingly difficult for government to make. In September 1986 a multiple exchange rate system based on an auction system (Window II) and a fixed exchange rate (Window I) was introduced. The objective of the new system was to allow the exchange rate to be determined by domestic demand and supply factors, promote trade liberalization, and divert foreign exchange held outside the banks into the banking system. Three months later the exchange rate was unified and all transactions took place at the auction rate. Liberalization of the exchange rate system went a step further with the introduction in 1988 of the *forex bureaux*. Since then, an interbank market in foreign exchange has been introduced and exchange rate regulations relaxed. These measures resulted in a substantial depreciation of the real exchange rate, especially in the first three to four years of the program (see table 5). The incentive structure is now more favorable toward exporting compared with the strong anti-export bias that prevailed prior to the introduction of the reforms.

Previous experience in Ghana had shown that serious balance of payments consequences could follow trade liberalization. At the same time, it was thought that imports should be used to relieve the critical import needs of the production sector. In keeping with this view, during the initial stages of the program, import liberalization through reduction of tariffs occurred within the context of import programming. This policy was pursued until 1986, when import programming ended. Import tariffs were reduced further after 1986. At the same time the negative import list was reduced, and in 1989 import licensing was abolished. Further trade reform involved the streamlining and lowering of nominal tariff rates to provide uniform incentives.
### Table 5

**Selected Economic Indicators, 1984–92**

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<td>Import volumec</td>
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<td>40.0</td>
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<td>37.0</td>
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<td>Credit to central government (net)d</td>
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<td>20.8</td>
<td>20.8</td>
<td>21.6</td>
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**n.a.** Not available.

a. Percent of GDP.
b. The public sector financial balance is public savings minus public investment. The private sector financial balance is private savings minus private investment.
c. Base year is 1980.
d. Million cedis.


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for industries. An export promotion package was put in place and the Ghana Export Promotion Council was revitalized to encourage nontraditional exports.

**Fiscal Reform**

Critical to the governance capacity of the state was the generation of financial resources. As noted earlier, the tax base had contracted as a result of the previous policies. At the time of the introduction of the Economic Recovery Program (ERP), it was recognized that there was a large potential for revenue generation. One of the principal elements of the Ghanaian success story was the ability of the government to raise tax revenues substantially. Rather than focus on cuts in expenditures to deal with the budgetary crisis, revenue generation was emphasized. The objective of the tax reform system was to improve the efficiency of tax administration, broaden the tax base, reform the punitive system of taxation, and shift the burden of taxation from the wage earners and cocoa farmers to the consumption of luxury goods by the better-off.

The devaluation of the currency and trade reform could be expected to increase explicit tax revenues. Compliance and an increase in efficiency were essential if these gains were to be realized. To increase the revenues from these measures a number of institutional reforms were made in the tax collection agencies. Extreme measures were taken initially to ensure that individuals and organizations that were required to pay their taxes did so. The restructuring of the tax-collecting organizations and the activities of investigating committees to check for tax evasion,
as well as the requirement that evidence of tax payment be produced before important documents (for example, passports) would be released, were important measures in the improvement of tax generation.

In accordance with the policy to improve revenue generation, the National Revenue Secretariat was formed in 1985. The purpose of the secretariat was to improve the revenue generation and collection process through a review of existing laws and measures with a view to needed changes, proposal of new revenue measures, removal of bottlenecks in revenue collection and administration, and the preparation of revenue budgets for the approval of the Ministry of Finance and Economic Planning. These functions had previously been performed by a unit in the Ministry of Finance and Economic Planning, headed by a director. Given the importance of revenue generation, the unit was upgraded and headed by a secretary of state who had direct access to the cabinet. The National Revenue Secretariat was thus given a greater degree of autonomy than its predecessor in the pursuit of its functions. The advantages of the autonomous unit were that the chain of command to the minister of finance was shortened considerably, and policy issues could reach the cabinet more quickly. The secretariat was also responsible for the 1986 restructuring of the Customs and Excise Department and the Central Revenue Department, which were formerly part of the civil service. These departments were reorganized into autonomous units headed by commissioners. At the time of the restructuring the border guards were absorbed by the Customs and Excise Department to reduce the number of tax collection units, and thus reduce costs. The Customs and Excise Department became the Customs, Excise, and Preventive Services (CEPS). The Office of the Revenue Commissioners was established, with units in each regional capital staffed by people committed to the program.

The issue of incentives became relevant. It was recognized that there was a need for improved quality of personnel, as well as personnel committed to revenue collection. It was unlikely that the graduates and professionals required by these agencies could be recruited given the unattractive pay conditions in the civil service, and it was impossible at the time to provide improved earnings for all civil service personnel. By removing the tax collection units from the civil service, this problem was solved at least cost. The CEPS used a bonus system to reward employees with a set proportion of the additional revenues collected.

To encourage compliance there was a reduction in income tax bands from nine in 1985 to six (including exemptions), as well as a reduction in tax rates from 55 percent to 35 percent.

Novel methods were devised to generate taxes from the informal sector, which normally escaped the tax net. The informal sector consists largely of illiterate and semi-illiterate entrepreneurs who do not usually keep accounts. They could not be expected to complete tax forms for their incomes to be assessed and taxed. To overcome this difficulty, standardized tax rates for the trades were established. The secretariat solicited the assistance of artisanal groups to collect taxes on behalf of the Internal Revenue Service, and paid them a commission for their efforts. One of the largest such organization is the Ghana Private Road Transport Union of TUC (GPRTU), which collects daily taxes on transportation and retains a predetermined percentage as commission. A paramilitary unit was established within this organization, with training provided by the government, to be responsible for the inspection of daily transport payments by drivers. Although it has been successful in collecting taxes on a daily basis, because the GPRTU was involved in the determination of the tax rate, it became a regressive system. Government was unable to increase the rates over a four-year period, and it was not until 1994 that the rates were reviewed.

Government expenditure policy was not geared toward cutting expenditures. Instead it was
designed to achieve levels of outlays or expenditures consistent with macroeconomic stability. The budgetary process in Ghana usually consists of four interrelated stages: formulation, authorization and approval, implementation, and evaluation. This process had fallen into disuse during the pre-ERP period, but it was reactivated and strengthened as a basis for control and rationalization of expenditures. In addition to this procedure, there were a number of units to deal with audits and the control of expenditures. These included the Expenditure Monitoring Unit, established within the Ministry of Finance and Economic Planning in 1989. The Financial Administration and Regulations, 1979, provides the framework for expenditure control, disbursements, and accountability.

Several other policy initiatives were undertaken to achieve expenditure objectives. The wage determination process was rationalized, and government made it clear that large wage increases would not be granted. Beginning in 1986, wage increases in subvented institutions were to be based on inflation, productivity, and profitability. In subsequent years wage payments were computerized to remove the substantial number of nonexistent workers on the payrolls. Several allowances that had been granted in response to political pressures in the previous period were consolidated into a basic wage or salary.

Although these measures could substantially reduce the growth of government expenditures, several subsidies remained in the system, the public service was overstaffed, and nonfunctioning state enterprises constituted a drain on the budget.

Public Sector Reforms

The policy toward state enterprises had several dimensions. The first was divestiture and outright liquidation. There was also the reorganization component, which initially involved the signing of performance contracts with the government. The laws that established state enterprises were repealed, and they were eventually replaced with the Statutory Corporations Conversions Bill, which allows them to register as limited liability companies with boards of directors. Their budgetary proposals have to be part of a three-year, rolling plan. If deficits were incurred for three years in a row, the companies would be liquidated.

Progress in the state enterprise divestiture program has been slow. Government's ambiguous attitude toward privatization in general, and foreign direct investment in particular, may explain why the program has not met with much success. There is a credibility gap because of previous government action—for example, the early support of the takeover of factories by workers, as well as statements by the leadership. Inadequate staff capacity to prepare corporate plans and performance agreements also initially slowed the process of monitoring firms that remained state-owned, and there have been difficulties in identifying the assets and liabilities of the corporations.

It was recognized that there was a need to increase salaries in the public sector to improve productivity, as well as to retain qualified personnel. Real average monthly earnings had been declining since 1974, and by 1983 they were about 14 percent of their 1974 levels. Increases in salaries, given the number employed, would have disrupted the government's effort to meet expenditure targets. It was established that there was a significant amount of overstaffing among the lower grades and a substantial amount of underemployment. To achieve the objective of improving productivity and remuneration, it was decided that shedding of labor in the lower grades was the solution. Labor would be laid off, with full benefits paid. It was expected that the laid-off workers would be actively employed in other sectors of the economy. It was decided that 45,000 workers would be laid off between 1987 and 1990. The actual figure separated from service was 29,000 by August 1990, and an additional group of 12,000 workers was let go in 1990. It has been much easier to lay off workers in the civil and educational ser-
vice than in other areas. The layoffs in the state-owned enterprises have been slow because of the problems these enterprises face in paying the end-of-service benefits. It was expected that by 1988, 63,000 workers would have been laid off in the state-owned enterprises; by 1990, 45,000 workers had lost their jobs. There has been concern that recruiting procedures have not been strictly followed. Despite this concern, public sector employment fell from 464,300 in 1985 to 186,300 in 1991. Provisions were made for the separated workers in the budget under the special efficiency heading, which was established to finance the re-deployment program, among other efforts.

In addition, attempts were made to improve civil service analytical, implementation, monitoring, and administrative capacity. As far back as 1987, the government had offered a compensation package to attract Ghanaians resident abroad into the service. At the same time, donor support was available to attract high-caliber Ghanaian professionals to positions in the civil service at differential salaries. This attempt failed, to a large extent because of civil service rejection of differential salaries for work that they considered similar to their own. Funded positions remained unfilled because of the attitude of civil service personnel. In a large number of cases, government resorted to employment of foreign consultants. This, however, did not improve the capacity of the civil service, nor did it improve the efficiency of the work. As in the earlier reform, ministries were expected to set up policy, monitoring, and evaluation units to be staffed by top-level professionals. Computerization of the ministries and the provision of office equipment and vehicles was arranged to facilitate the operations of the ministries. While donors were supporting these reforms, they were also fragmenting the civil service through the establishment of special units that offered substantially higher pecuniary and nonpecuniary benefits for the implementation of donor programs. Each program or project had a secretariat staffed by some of the best individuals from civil service. It seemed that there was competition among donors to establish such units for their individual projects. It is understandable that each donor wanted to effectively implement its own projects or programs, but there were two problems with this approach. The first was the fragmentation of the service. The second was that the processes and methods used in the projects did not filter through to the rest of the service, and thus were not internalized.

The Response of the Economy to Reform

The data in table 5 suggest that the response of the economy to the reform program can be divided into two periods: the initial years, 1984–89, and the period of political transition, 1990–94.

In the 1984–89 period, real GDP grew an average of 5.7 percent a year. The rate of inflation fell to 40 percent in 1984 from 123 percent in 1983, and fell further, to 10 percent, in 1985. Export volumes increased by 2.02 percent in 1984, compared with a decline of 27.8 percent in the previous year. The ratio of the current account deficit to GDP declined, and there was a sharp drop in the ratio of the parallel and the official exchange rate.

The significant relative price changes caused by the devaluation, the existing excess capacity, the large parallel economy, and the good rains of 1984 brought about an immediate, substantial response to the program. The existence of the parallel market meant that there was a shift of supply from the parallel market outlets to the official market outlets, so that there were no significant costs involved in responding to the change in relative prices.

Between 1990 and 1993, however, the rate of GDP growth decelerated. From an average of 5.7 percent between 1984 and 1989, it dropped to an average of 4.3 percent a year between 1990 and 1993. The rate of inflation also increased sharply in 1990. The external current account deficit, which had remained below 2 percent of GDP, in-
increased sharply to 4.4 percent of GDP in 1990, and has remained relatively high.

A similar pattern of dichotomy between the earlier years and the 1990–93 period can be observed in the fiscal response to the adjustment program.

**Fiscal Response: 1983–89**

The initial period, 1983–89, is characterized by an improvement in the ratio of the budget balance to GDP and an improvement in the ability to achieve budget balance and revenue targets. Total expenditures were within the target area for most of the period, but this was achieved at the expense of restraints on capital spending (see table 6).

Implementation of the ERP saw an almost immediate reversal of the poor state of budgetary affairs. The budget deficit/GDP ratio fell to 1.8 percent in 1984, with a surplus in 1986. The improvement in the ratio was the result of success in keeping the size of the budget deficit below the 1982 levels and the rapid increase in output. Until 1988 the size of the actual budget deficit was

<table>
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<th>Table 6</th>
<th>Budgetary Performance, 1983–94</th>
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<tr>
<td>Budget balance (million cedis)</td>
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<tr>
<td>Proposed</td>
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<td>Actual, as proportion of proposed target</td>
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<td>Revenues</td>
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<tr>
<td>Annual percentage change⁵</td>
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<td>Revenues</td>
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</tr>
</tbody>
</table>

n.a. Not available.

a. Provisional estimates obtained from the 1995 budget statement.
b. Nominal values.

Source: Budget proposals obtained from various budget statements. Actual values obtained from Statistical Services, *Quarterly Digest of Statistics*, various issues.
smaller than had been presented in the budget proposals, and the surpluses achieved were larger than expected (table 6).

The ability to achieve tax revenue targets improved considerably between 1984 and 1988, with an increase in the probability of achieving targets as well as a widening of the sources of taxes brought about by the improved efficiency in tax collection.

In 1987 and 1988 actual tax revenues were larger than had been budgeted (table 6). Grants have been important in contributing to the budget surpluses; if they had not been included in the calculation of the budget balance, it would have registered a deficit in each year.

Tax revenues as a percentage of GDP increased from 4.6 percent in 1983 to 12.78 percent in 1987, and they remained at approximately 12 percent (table 6). The tax base increased because of the increase in output, the improved efficiency in tax collection, and the widening of the tax base. The substantial aid inflows not only allowed an increase in imports, but also permitted the government to embark on rehabilitation of the economic and social infrastructure, which would contribute to building its support base in the rural areas. Nominal and real revenues grew continuously between 1983 and 1988, and the rate of growth of nominal revenues decelerated in each year between 1986 and 1990. Revenues had declined to such low levels in 1983 that the sharp increases in 1984 and 1985 are to be expected.

The improvement in the budgetary situation occurred within the context of increases in government expenditures. The substantial increases in tax revenues, combined with foreign grants, permitted increases in discretionary expenditures and improved governance capacity. This is the one reason—unlike the experiences of other countries—that the Ghanaian reforms proceeded without substantial reductions in government expenditures and their resulting adverse effects. Nominal and real expenditures grew faster between 1983 and 1989 than in the seven years prior to reform. Nominal revenues grew an average of 55 percent between 1983 and 1989, compared with an average of 36 percent between 1975 and 1982. The rate of increase in nominal expenditures slowed between 1985 and 1989 after the initial increase of 81 percent between 1983 and 1984 (table 6).

Expenditures would have grown more rapidly if restraints had not been imposed. In most years this restraint was achieved through cuts in capital spending. In 1985, for example, total expenditures were limited because of insufficient foreign and other noninflationary inflows. Planned net lending to state enterprises had to be reduced significantly, and development projects with a low priority ranking were not implemented. Despite the restraints on the expansion of capital expenditures, its share of total expenditure increased from 8 percent in 1983 to 21.9 percent in 1989 (table 7). Development spending has constituted a significant proportion of this category of expenditure.

The wage and salary increases, as well as the restructuring of the pension scheme, have affected expenditures and can explain some of the difficulties in restraining current expenditures during the first four years. Nominal wages in the public sector increased substantially during the period of economic reform. The increase in monthly average earnings during the period from 1983 to 1986 was higher than increases in the five years prior to economic reform, and between 1984 and 1986 it was higher than the rate of inflation5 (Jebuni, Oduro, and Tutu, forthcoming). Salary-related expenditures increased from 23.3 percent of total expenditures in 1983 to 38 percent in 1986, and fell to 34.5 percent in 1989 (table 7). As a share of current expenditures, however, this item

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5 The minimum wage rose from C35 in April 1984 to C52 in December 1984 and to C70 in January 1985.
increased from 27 percent in 1983 to 46 percent in 1987, declining to 44.3 percent in 1989.

These salary increases may be considered a means of gaining support for the economic reform program. They represented an attempt not only to gain the support of the general populace, but also to reduce the discontent of the bureaucracy, which had benefited from the rent-seeking system that was to be abolished. This support was achieved in the short run at the cost of the failure to implement fully the capital expenditure program. The redeployment program thus provided some relief. Recorded public sector employment declined by more than half between 1985 and 1990.

**Fiscal Response, 1990–94**

Unlike the earlier period of adjustment, the last four years have seen the emergence of large budget deficits, a decline in the ability to attain tax revenue targets (in contrast to the improvements of the previous period), and large expenditure overruns (table 6). These developments may be attributed to the political developments of the time—the transition to democracy, institutional restructuring, laxity as the aid inflows increased, and the changing structure of government spending.

In 1988 the secretary of state of the National Revenue Secretariat was given additional responsibilities, and by 1991 the secretariat had lost its ministerial status. The secretariat was brought back under the Ministry of Finance and was headed by a director responsible to the minister of finance and economic planning. It maintained a certain degree of autonomy, and it did not have to go through a long chain of command to reach the minister. This could be interpreted as complacency on the part of decisionmakers, who may have considered that the favorable tax performance of the previous years would continue. An alternative explanation is that the targets became too ambitious given past achievements. It is unlikely that this is a major reason, because the rate of increase in proposed revenues was much lower after 1988 than it had been earlier. Other possible explanations may be laxity because of substantial foreign aid inflows. Between 1988 and 1991, foreign grants tended to be larger than expected (table 6). The movement into indirect monetary control through treasury bills made it easier for the government to finance its deficit by borrowing from the nonbanking public. This may have reduced pressure on government to generate resources through taxes.

The capital expenditure budget has had to be more severely constrained since 1988 than in previous years; at the same time, the overrun of the current expenditures has worsened. Expenditure
slippages have become more pronounced since 1992 (table 6). In that year salary-related payments in the budget increased by 62 percent as government responded to pressures from the civil service to raise salaries during an election year. Capital expenditures increased by 69.9 percent at the same time, largely because of the quadrupling of the Special Efficiency Fund, which makes payments to redeployed workers.

Interest payments on public debt have been rising since 1989, both in absolute terms and as a share of total expenditures. The rise in interest payments on domestic debt has been quite dramatic. In 1989 the interest on external debt exceeded domestic debt interest payments. By 1991, domestic interest payments had quadrupled in nominal terms and were twice the value of payments on external loans. In 1993 interest on public debt had risen to 18 percent of total expenditures, and provisional estimates for 1994 indicate that they have risen to 20 percent (table 7). The increase in nominal interest rates since 1990—as government financed its deficit by borrowing from the general public—can explain the growing significance of this line item. The interest payments may be perceived as introducing rigidity into expenditures, because these are obligations the government has to meet.

A review of public expenditures in 1993 indicated that the expenditure control mechanisms have not been operating as they should. It was found that ministries were not following the established procedures for the purchase of supplies (Ministry of Finance and Planning 1994, p. 19). There have also been problems in enforcing the rules governing the authorization of transactions financed by the government’s accounts. Prior approval from the controller and accountant-general’s office is required, but this does not happen. In the 1989 budget statement the expenditure overruns were attributed to the depreciation of the cedi and the policy of improving the quality of repairs. It is not entirely clear how the latter can explain these overruns, since it would be expected that the projected costs would have incorporated the required quality standard. In the 1990 budget, concern was expressed again about the problem of excessive spending. The measures suggested to control this problem—ensuring that tender values do not exceed programmed expenditures, strict enforcement of regulations concerning variation orders, and ensuring contractors conform to the investment schedule and financing plan assumed in the public investment program—may be indicative of the underlying causes. Most of the laxities in expenditure control and the budgetary system were in existence prior to 1989.

The question then is why the problem did not emerge during the years from 1983 to 1988. It is possible that complacency, which has been suggested as the explanation of the revenue situation, may be relevant here. The substantial inflow of foreign financing between 1989 and 1991, which was equivalent to about 10 percent of revenue during those years, may explain both the lack of pressure to generate domestic resources and the pressure on ministries and departments to spend.

The problem may have been compounded in 1987, when monthly average earnings deflated by the consumer price index increased only 1.2 percent, and fell by 0.14 percent in 1988. The dismantling of the control system had removed rent-seeking activities as a supplement to slowly increasing real incomes. The alternative may have been to take advantage of the pressure to spend brought about by the inflow of foreign grants and loans. Ghana’s involvement in peace-keep- ing operations in Liberia and the hosting of the NAM conference in 1991 also put pressure on expenditures. The transition to democracy in 1992 had no small effect on the size of government expenditures, and resulted in the largest expenditure overrun since the economic reform program in 1983.

In 1994, despite the failure to achieve revenue targets, disappointment in aid inflows, and the expenditure overruns, a fiscal surplus was recorded. This is explained by the inclusion of divestiture funds in above-the-line items.
Governance and Structural Adjustment in Ghana

Governance Capacity and the Adjustment Program

This study has defined governance capacity as being determined by the ability to articulate an alternate vision and present a credible program, the commitment and credibility of the implementing government, the ability to raise government revenues substantially, and the ability to develop alternate supportive interest groups while remaining autonomous. This section examines the extent to which Ghana’s program and implementation were consistent with these criteria.

The Initial Phase, 1984–89: Commitment and Credibility

Recent literature based on structural adjustment experience suggests that commitment and credibility are essential for successful adjustment.

The PNDC government, unlike the Busia government, showed its leadership by the decision to change course when it realized that its initial program was worsening the economy. Once it had made the decision, it committed itself to the new course of action. This commitment was indicated in a statement made by the chairman in the aftermath of the coup attempt two months after the launching of the Economic Recovery Program (Rawlings 1983, p. 25).

We may anticipate that soon the floodgate of protests against human rights violations will be opened as the next tactical move of organized hypocrisy, but for the defence of our revolution we will run that risk. If we must use our strength to crush actions which threaten the process so be it.

The repressive nature of the regime, with its intolerance of opposition, was indicative of purpose of intent. The departure of original members of the PNDC who held views contrary to those of Rawlings was also a positive signal of commitment to the chosen economic strategy. The Rawlings regime had earned a reputation for carrying out its intentions by handing over power to a civilian regime in 1979.

A second indication of the commitment of the government is the speed of implementation of policy measures crucial to the achievement of its stated objectives. A major objective of the program was to improve the incentives for production and export and to increase the availability of foreign exchange. The immediate exchange rate policy actions implemented in April 1983 and the subsequent, frequent devaluations between October 1983 and September 1986 must have sent strong signals that policy reversal was unlikely. No previous government had undertaken such a dramatic devaluation of the currency, and continued with a series of devaluations despite the dissatisfaction expressed by the populace.

A decline in the size of the budget deficit was achieved in 1983, despite the increase in nominal government expenditures. This was managed by the more than doubling of revenues that accompanied the exchange rate adjustments. Another indicator of the improvement in the fiscal effort was adherence to established targets. The actual deficit in 1983 was less than half that proposed in the budget. This was achieved primarily through restraint in the expansion of expenditures, particularly capital expenditures. Actual recurrent and capital expenditures in 1983 were 88 percent and 14.7 percent, respectively, of their proposed levels.

It is unlikely that a problem of time inconsistency emerged during the initial three years of the program. It was clear that the policies pursued prior to 1982 had failed, and there was a need to adopt and implement a new approach. At the Paris donor conference, financial resources had been pledged over a three-year period, thus committing the government to the program over that interval. The lack of alternative sources
of funding at the time was another important determinant.

As a result of this commitment, Ghana achieved a 58 percent compliance with the conditionalities agreed upon with the World Bank and International Monetary Fund during the 1983–88 period. This is considerably above the compliance efforts of Kenya, at 38 percent, and Ecuador, at 15 percent (Mosley, Harrigan, and Toye 1991, p. 136). Trade reform was extensive and rapid; according to Levy (1993), complete compliance was achieved.

The government’s commitment to implement the program and its technical soundness made it credible to foreign donors. This generated a substantial inflow of the external resources that were crucial to the success of the changes introduced. As previously noted, these resources were important in the rebuilding of the dilapidated infrastructure, the rehabilitation of the traditional export sector, budgetary support, and the financing of the foreign exchange auction system introduced in 1986.

On the domestic front, however, there was a credibility gap. The government’s ideological stand prior to reform did not endear it to the private Ghanaian business community. Even when the government had shown its changed perspective by introducing market reform, many private sector operators remained skeptical. Their doubts were increased by the government’s ambivalence toward the private sector. In part, this attitude must have been the product of a deep ideological conviction that economic reality forced it to change. The flow of external assistance contributed to this ambivalence, because it meant that development of the private sector was not essential to the initial implementation and success of the program.

**Program Articulation and Interest Groups**

Figure 2 shows that the program was implemented in Ghana without the kinds of protests that usually accompany such reforms. Compared with the previous reform attempt, when numerous indus-
trial strikes arose to protest the reforms, there have been no significant labor protests against the current program. Labor unrest has been nowhere near the levels of the 1970s or 1980s. Indeed, strikes have never been as uncommon during Ghana’s postindependence experience. It is argued in this section that this was, in part, the result of the manner in which the program was presented to the Ghanaian public and the ability of the government to organize alternative interest groups while escaping capture.

Although the program was drawn up without the broad consultations that had taken place in the previous reform program, it was presented to the nation as the only viable option for national survival. In its presentation, the government portrayed itself as placing the national interest above its own survival. This was made clear in radio and television broadcasts to the nation after the launching of the program in the 1983 budget.

Only a government which places the interest and the very survival of the nation before its own interests would have come out with such an austere budget. If the PNDC Government was concerned with cheap popularity, we would not have presented you with such a budget. The medicine is bitter, I agree, but it is necessary [Rawlings 1983, p. 16].

Opponents of the reform program were portrayed as opportunists seeking their own self-interest: “They have suddenly and hypocritically become defenders of the poor workers, but only as long as this will help them regain their lost power and privileges” (Rawlings 1983, p. 16).

As discussed earlier, one of the main expected losers in the reform program was the urban population, particularly the labor movement, which is also the most politically vocal group. Fear of urban unrest had led previous governments to tax rural farmers to subsidize urban consumption through the imposition of a controlled trade and price regime. The urban population had also benefited from subsidies on imported commodities made possible by the overvaluation of the currency, as well as explicit subsidies. For instance, while it was popularly believed that the subsidy on kerosene would be of greatest benefit to rural farmers, the major portion of the subsidy went to urban consumption. Estimates in 1983 showed that 52 percent of kerosene was consumed in urban areas, together with industrial and commercial users.

The PNDC’s initial conception of the economic woes of the country was that they were the legacy of the exploitation of the masses and the corruption of the system. This belief was important to the extent that it recognized that reform of the system required the establishment of alternate interest groups. This was the basis of the formation of the Workers’ Defence Committees (WDCs), the Peoples’ Defence Committees (PDCs), and the Civil Defence Organization (CDO). These were voluntary organizations, funded by the state. Formed to mobilize the people for development, these groups were important in organizing on the shop floor and neutralizing the possible protests and threats to the program from the Trade Union Congress (TUC). The laws and regulations governing public boards and institutions, as well as state enterprises, were changed to ensure that members of the WDCs were included in their boards of directors. The WDCs increasingly became the center for the expression of worker interests; some became managers of state enterprises. Their survival depended on the survival of the regime itself.

Government repression also played a major part in the relative ease with which Ghana’s program was implemented. The philosophy of the government was that individual rights were of less importance than the collective rights of the people. One official observed of the PNDC: “This government was prepared to take action. It also had a strong constituency among those who hold the gun. The population knows that if you complain, you will be silenced. If you did misbehave you would be taken care of” (quoted in Herbst 1991).
In a critique during his 1988 Danquah Lectures, the role of repression is made clear by Adu Boahen: “We have not protested or staged riots not because we trust the PNDC but because we fear the PNDC! We are afraid of being detained, liquidated or dragged before the CVC or the NIC or being subjected to all sorts of molestation” (quoted in Jeffries 1991, p. 169).

This repression, compounded by state control and monopoly of both the print and electronic media, made it difficult to determine the extent of support for the program among workers and other interest groups, especially the urban masses who have been the traditional enemies of market-based economic reforms. The increase in real wages that occurred in the first three years of the program suggests that it must have favorably affected the economic conditions of the urban masses—or at least did not worsen them. As indicated earlier, the economic situation before the reform program was such that most Ghanaians had to purchase commodities in the parallel market. Very few, if any, were benefiting from the controlled system. Furthermore, to cope with the hardships most people had taken second jobs, so that a decrease in wages or outright loss of a job would not have meant as much as it may have seemed (Herbst 1991).

From 1987, however, when employment rationalization in the public sector and the divestiture of state-owned enterprises were introduced, things began to change. Redeployment had a checkered history. It appeared unpopular at the beginning; the first group of workers who were laid off did not receive their terminal benefits or compensation for a long period of time. The payments system was improved, however, and the prompt payment of substantial accrued benefits persuaded some workers to volunteer to be laid off. By 1990, budgetary pressures on the government again created payments difficulties. Payments to workers of divested state enterprises also became a problem. These enterprises were making losses, and yet had money to award themselves several entitlements. The divestiture of these enterprises transferred the burden of the payment of entitlements to the state.

While the state was laying off workers, the private sector was also rationalizing employment in an environment that was increasingly competitive following the introduction of trade liberalization in 1986. The actions of the two sectors led to rising unemployment. Combined with cost recovery in education and health, workers felt betrayed by the government. Although the government argued that it had kept faith with workers and that the unemployment was short term, it is clear that these arguments were not convincing to those adversely affected.

Beneath the apparent calm generated by repression was a restive labor force held in check. The transition to political liberalization, as will be illustrated below, was to provide a vent and expose the government’s vulnerability and failure to win the confidence of the urban masses.

The Bureaucracy and Adjustment

The bureaucracy affects the implementation of economic reform programs in two ways: (1) through its technical and administrative capabilities and (2) through its role as a power block and interest group.

Pervasive administrative weakness hampered policy formulation and implementation in Ghana. In part, this arose from the general deterioration in the economy discussed earlier. The bureaucracy was preoccupied with regulating the system and issuing licenses and permits. Basic data gathering and analytic and accounting skills seemed to have disappeared. The one reason Ghana’s reform effort did not collapse is that the same senior professionals who had convinced the government of the need to change continued to do the relevant programming and policy formulation.

To compensate for this administrative weakness, according to Callaghy there was “a real and
The attempt to reform and improve the capacity of the bureaucracy from 1987 onward did not succeed. This technical and administrative weakness must partly be responsible for Ghana's inability to absorb the increased external financing after 1989.

In the initial phases, program design and implementation were carried out by task forces and several committees. The result was that the top administrators of the policies were not involved in their design. This created implementation problems. As one top official of the Ministry of Finance and Economic Planning put it: "To the extent that they did not feel related to the formulation you could not count on them for implementation" (personal interview by the author).

As an interest group, the bureaucracy was opposed to the adjustment program. Their opposition was to be expected, because they were the main beneficiaries of the rents arising from the controlled system. Although these rents had disappeared with the virtual collapse of the economy, it was thought that any re-sumption of growth in the economy would see the reemergence of the rents. Up until 1989, when import-licensing was abolished, the bureaucracy still argued in favor of the imposition of controls.

The immediate increase in government revenues as a result of the reform program allowed for annual salary increases for the entire public service between 1983 and 1986. This provided partial compensation for the lost rent. The basis of the increases changed after 1986 to reflect productivity and efficiency gains. The proliferation of foreign funds and projects provided nonpecuniary benefits to the bureaucracy, and in some cases explicit wage subsidies. These activities gained the acquiescence of the bureaucracy, if not their voluntary compliance.
The Transition, 1990–94

The transition in Ghana is associated with a general deterioration in all indicators of economic performance. The rate of growth of the economy, which was above 5 percent annually between 1984 and 1989, dropped to 3.3 percent in 1990, and has averaged about 4 percent in the five-year period of 1990–94. The period of 1992–94 was supposed to be one of accelerated growth, with expected growth rates of between 6 percent and 8 percent. Instead, as indicated earlier, the rate of growth decelerated. Agricultural production decreased by 2 percent in 1990, and has since alternated between decline and positive growth. Wide divergences occurred between government program targets and outcomes. For all years since 1989, except for 1991 and 1994, huge budgetary deficits were recorded after surpluses had been projected. The 1994 surplus was recorded because of the sale of part of the government share in the Ashanti Goldfields Company (AGC). Rates of inflation were much higher than had been programmed. What happened? Was this a reflection of the general characteristics of transition to democracy, or was this a special Ghanaian phenomenon?

At the time of the adjustment program in Ghana, capacity utilization was very low and stocks were depleted. Capacity utilization in manufacturing was estimated at 18 percent in 1984. The initial response was thus based on utilizing this capacity. Flows of foreign aid allowed stocks to be built up and industrial capacity utilization to increase. In view of the depth of the crisis in Ghana, this process could have been expected to take between three and four years, followed by substantial investment to sustain the growth. This did not occur. There was a domestic credibility gap born out of the government’s previous ideological flirtation with socialism, its attitude toward the private sector, and the use of repression. This manifested in the failure of domestic private investment to increase substantially. In a survey of manufacturing enterprises in Accra in early 1994, Asante (1994) found that 77 percent of the firms interviewed regarded the government attitude toward business as a problem for investment: 27.3 percent thought it was a major problem, and for 50 percent it was a moderate problem. Only 23 percent of those surveyed did not consider government attitude to be a problem. As shown in table 6, overall investment increased, but it remained low compared with other, less-developed countries. The expected private sector investment did not occur. The program was therefore largely driven by public investment, funded by external resources. When the level of external support expected did not materialize in the 1990s, the program ran into a crisis.

This credibility problem not only led to the nonresponse of private investment, but also to substantial increases in expenditures and an inability to regain control of expenditures after the elections held during the transition. Wide disparities emerged between government expenditures and revenues, which led to budgetary deficits. These, in turn, put pressure on prices and the balance of payments.

To compensate for the widening disparity between expenditures and revenues, government resorted to short-term borrowing on the domestic market. As discussed earlier, this resulted in substantial fixed interest obligations on the budget in subsequent years. Interest payments as a proportion of GDP, which were less than 1.5 percent between 1984 and 1990, rose sharply to an average of 2.9 percent of GDP between 1991 and 1994, with 1993 recording 3.4 percent and 1994 above 4 percent. These interest payments are dominated by interest on the domestic debt, which accounted for about 70 percent of total interest payments in the last two years.
The transition to democracy started in earnest in 1990. Some might argue that it started with the district elections in 1987, but although these elections were important in generating grassroots participation in local development efforts, they were not conceived in the context of a national transition to democracy. The national effort started when the Chairman of the PNDC, Flight-Lieutenant Rawlings, charged the National Commission for Democracy with collating views from all ten regions of Ghana on the evolution of a democratic system for Ghana in July 1990. This involved holding regional forums and seminars to solicit reactions on the way forward. Following the submission of its report in March 1991, which recommended the establishment of a multiparty democracy, a committee of experts was established to draft proposals for the Fourth Republican Constitution. This was followed by a Consultative Assembly that considered the proposals and drafted a Constitution, which was subjected to a national referendum in 1992. National elections were then held and won by Flight-Lieutenant Rawlings and his National Democratic Congress (NDC).

The elections themselves generated political competition among the three main contending parties, the NDC, the New Patriotic Party (NPP), and the People’s National Convention (PNC). They did not generate substantially new economic ideas or alternatives to the program the PNDC government was pursuing. The main issues involved human rights and questions of accountability and probity. The result of the elections was a virtual one-party Parliament.

The stages involved in this process put pressure on government expenditures, even though some external assistance was available to finance the effort. All through the process it was clear that the incumbent government was interested in retaining power. This self-interest exposed the government to two kinds of pressures to increase expenditures: pressures from wage demands and the need to increase discretionary expenditures for political gain (pump-priming).

There is always a tension in adjustment programs between the need to hold down public sector expenditures through wage restraint and increased wages as an incentive for greater productivity and compliance. Although wages must be related to productivity, there is also a moral hazard in expecting honesty and increased productivity from underpaid workers. The Ghanaian program was never able to resolve this tension. In the initial phases the government functionaries were expected to receive their salaries from their initial places of work. Allowances to compensate for the increased responsibility were not fixed, at least for the first three years. The fear was that there would be spillover effects from such action on general wage demand. The same dilemma is indicated by the government’s inability to fix wages, salaries, and allowances for its own ministers of state, parliamentarians, and other functionaries managing the institution established under the 1992 Constitution, almost two years into the Fourth Republic. In the past, government had responded to wage demands through threats to leadership of the labor movement, repression, or selective compromise. As indicated earlier, this did not reduce the government’s vulnerability to the urban masses. When it became clear that the government was vulnerable because of its self-interest, demand mounted for wage increases. This resulted in a 60–100 percent salary increase for the civil service in 1992, which had an immediate spillover effect in the public sector as a whole.

Expenditures for political gain are undertaken by all governments, from the national democracies such as the United States to transitional democracies such as Ghana. These expenditures usually occur under the capital account of the budget, particularly development expenditures. While one can document the increases in these expenditures, it is impossible to infer the motive. While ministry officials have indicated that the sharp depreciation in the cedi played a major role in budget-
ary overruns in development expenditures, they also indicate that part of the problem of expenditure control in this component is political. Implementation of politically sensitive projects that were not given priority, and then switching back to priority projects, has given the government considerable difficulties in monitoring these expenditures.

The government initially established credibility for taking action against revealed cases of corruption or abuse of office. The special organizations developed by government were important in exposing such corrupt behavior and malpractice. With political liberalization, both the emerging private press and the state-owned media started publishing stories of impropriety and malfeasance in public places. This undermined the moral authority of some of the bodies responsible for implementing the program, such as the Committee for the Defence of the Revolution, the Tribunals, the Citizens' Vetting Committee (CVC), the National Investigation Committee (NIC), and the Civil Defence Organization (CDO). Some of the stories were certainly false, but they increased the public perception of corruption in the system. Failure of the government or Parliament to take public action on alleged instances of abuse of public office intensified the negative public perception of government credibility. The auditor-general's report on the public accounts of Ghana for 1992 revealed substantial evidence of embezzlement of funds and failure to comply with established procedures in the purchase of supplies and equipment. No court examination or official investigation of these allegations has been made; if any inquiries have been conducted, they have not been made public. The failure to take public action on allegations of abuse created a credibility problem for government and removed an essential aspect of governance—public trust of the behavior of officeholders.

The moral authority of the special interest groups, having been challenged by allegations of malfeasance, was damaged, and their legal foundation was removed by their lack of recognition by the Constitution. They were now perceived by the public as powerless, and a passing phase of Ghanaian history. The government was saddled with the problem of finding ways to absorb these groups into the system at a time when employment in the public sector was frozen and workers were being retrenched, to maintain them, or make some financial settlement with them. All three methods were tried.

Adjustment of revenue-collecting agencies and the bureaucracy to declining incentives was also important in explaining the slippages in the transition. This borders on the reciprocity aspects of governance. According to this concept, “Actors contribute to the welfare of others in the hope that, at some unspecified time in the future, they will receive some appropriate consideration in return” (Bratton and Rothchild 1992, p. 271). As discussed earlier, to motivate the revenue-collecting institutions, government had removed them from the civil service and provided improved salary and benefit conditions. These conditions were not maintained. For four years prior to the 1994 fiscal year, these incentives were gradually eroded by inflation. In 1994, however, salaries were increased. In the interim, the declining real wages led to declining staff morale and efficiency. This problem was acknowledged by government, although belatedly, when in the 1994 budget the minister for finance and economic planning stated: “Misdescription and misclassification as well as blatant collusion between importer and officials have sadly become rather pervasive” (Ghana 1994, p. 24).

Under the control regime, the bureaucracy extracts its rents mainly through the revenue side of the budget. When the system is liberalized and these revenue-side rents disappear, there is a tendency to adjust through the expenditure side. This could take the form of inflating expenditures or simply refusing to follow financial regulations. The slippage in adhering to financial regulations in the acquisition of supplies and the embezzle-
ments recorded in the auditor-general’s report could be interpreted as the adjustment of the bureaucracy to declining real wages in a liberalized economy.

**Conclusions**

Ghana has gone through two experiences of economic reform programs: 1967–71 and 1983 to the present. The first program was initiated by an unelected military government that handed over power to an elected civilian government two years into the program. The second was implemented by a military dictatorship that evolved into an elected civilian government. Both programs involved movement away from a controlled economy to a more liberalized one. In both instances economic reform was necessitated by the slowdown in economic growth and internal and external disequilibria. The extent of the disequilibria, however, differed significantly between the two cases.

A certain pattern of performance can be observed for both programs. In each case, the initial phases of stabilization appeared to be successful. For both reform programs the shift to accelerating the growth rate was unsuccessful. While the first reform attempt was reversed, however, the current program has been sustained.

The differences, it is argued in this chapter, arose because the first reform lacked both external and domestic credibility. This was the result of inconsistencies in the program, lack of a well-articulated alternative, the lack of commitment of government, and a weak leadership. The current program was largely successful in the initial phases, exhibiting capacities in all these areas. The program was technically sound, and the government was committed to its implementation. This made it credible to the external donor community and ensured substantial flows of the external assistance crucial to the initial phases.

This credibility gap was not balanced by a motivated and efficient bureaucracy. As indicated earlier, the attempt to build the capacity of the bureaucracy was a complete failure.

The government was able to develop new interest groups that appeared committed to the program: the Committee for the Defence of the Revolution (CDR), the CDO, 31st December Women’s Movement (31 DWM), Office of the Revenue Commissions, and the like. These groups were instrumental in articulating and “selling” the program to the Ghanaian public, as well as raising substantial government revenues. They were also used to suppress the traditional interest groups that could have opposed the program. Nevertheless, the existence of these interest groups as the main source of government support could not be sustained during a democracy. There was thus a domestic credibility gap.

The creation of organizations and agencies to implement specific aspects of the program allowed government to effectively bypass the bureaucracy. The substantial and rapid increases in foreign inflows in the initial five years allowed the reform program to proceed without any special overtures to the private sector to participate in the program. Because of the substantial foreign inflows, the problems arising from the existence of a domestic credibility gap did not emerge in the initial years.

The failure to restructure the bureaucracy to improve efficiency and commitment and to fully integrate the private sector into the decision-making process later emerged as problem that could have derailed the program. This was reflected in the increased expenditure overruns, the stagnant investment rate, and the slowdown in average growth rates. As the rate of growth of foreign inflows slowed, the weakness of the strategy of nurturing close links with the ex-
ternal donors without developing a broad-based domestic support network emerged. With a weak support base among the vocal urban groups, particularly because of the retrenchment program, the government’s strategy of maintaining a support base through expenditure overruns threw the economy off balance.

The PNDC government under Flight-Lieutenant Rawlings mortgaged its political capital to carry out a far-reaching reform program in Ghana. It was largely successful in the initial years. In the transition, as the government’s electoral survival became uncertain, it lost control of its expenditures. Getting back on track will depend on whether the NDC government under Rawlings and subsequent democratic governments consider that they have enough political space to exert some leadership and place long-term economic considerations ahead of short-term political gains.
Appendix

Principal Political Dates and Regimes

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 6, 1957</td>
<td>Independence, with Nkrumah as prime minister and the Convention People’s Party (CPP) as the ruling party.</td>
</tr>
<tr>
<td>July 1, 1960</td>
<td>Ghana becomes a republic within the Commonwealth and Nkrumah becomes president.</td>
</tr>
<tr>
<td>February, 1966</td>
<td>Military coup d'état overthrows Nkrumah and establishes the government of the National Liberation Council.</td>
</tr>
<tr>
<td>August &amp; October, 1969</td>
<td>Elections under new Constitution won by Progress Party, led by Busia as prime minister.</td>
</tr>
<tr>
<td>January 13, 1972</td>
<td>Military coup d'état overthrows Busia government and establishes the National Redemption Council (NRC) led by Colonel Acheampong.</td>
</tr>
<tr>
<td>June 4, 1979</td>
<td>Military insurrection overthrows Acheampong and establishes the Armed Forces Revolutionary Council led by Flight-Lieutenant Rawlings.</td>
</tr>
<tr>
<td>June &amp; September, 1979</td>
<td>Elections held under new Constitution and won by Peoples National Party led by Limann as president.</td>
</tr>
<tr>
<td>December 31, 1981</td>
<td>Military coup d'état overthrows Limann’s government and establishes Provisional National Defence Council (PNDC) led by Flight-Lieutenant Rawlings.</td>
</tr>
<tr>
<td>November, 1992</td>
<td>Elections under new Constitution won by National Democratic Congress (NDC) led by Flight-Lieutenant Rawlings as president.</td>
</tr>
<tr>
<td>January 7, 1993</td>
<td>Fourth Republic is inaugurated.</td>
</tr>
</tbody>
</table>
Bibliography


Governance and Fiscal Reform: A Study of Pakistan

Hafiz Pasha

The objective of this chapter is to examine the relationship between governance capacity and the success or failure of the fiscal reform pursued in Pakistan in recent years. Some measures of governance capacity are the ability of the state to design and enforce a common set of rules for the orderly and efficient conduct of economic activities and to autonomously develop policies that are not subservient to the interests of particular economic and social groups.

This chapter focuses on the area of fiscal reform for a number of reasons. First, there is a general recognition of the magnitude of the fiscal imbalance, and that reduction in the budget deficit constitutes the core of the structural adjustment process. Second, the existing taxation system and the pattern of expenditure clearly highlight the quality of governance in the universality of the application of the tax code; “state capture,” either in tax breaks or subsidies to special interest groups; and the general level of inefficiency and corruption. Third, fiscal reform has well-defined, sizable, and more or less immediate distributional consequences, and a study of this process clearly demonstrates how the government must be politically articulate and sell its vision of change to justify the reform, how coalitions are built to either force through or block the reform, and how the process of bargaining takes place whereby compensation mechanisms are found to minimize resistance by potential losers.

The chapter demonstrates that the relationship between governance capacity and the process of economic reform is complex. It shows that the same government can meet with exceptional success in one area of reform, while it is confronted with ignominious failure in another. It appears that success or failure depends upon the combination of factors of governance capacity that come together in a particular situation. The chapter also discusses major ongoing fiscal reform episodes, part of the agreement with the International Monetary Fund (IMF) on the Extended Structural Adjustment Facility (ESAF) and the Extended Fund Facility (EFF), and concludes that the present government will have to adopt ingenious approaches and demonstrate a high level of governance capacity to successfully orchestrate these reforms.

The chapter has both a macroeconomic and a microeconomic focus to facilitate an in-depth study of the process of fiscal reform. It is organized as follows. The second section outlines the initial conditions of fiscal reform in the coun-
try toward the end of the 1980s. The third section sets out the imperatives for tax reform and derives the implications for the reform strategy. We then analyze the degree of success and its determinants in two major areas of reform: the introduction of presumptive and withholding taxes (in the fourth section) and the broadening of the tax base with rate reductions (in the fifth section). The sixth section discusses ongoing reforms of the general sales tax and import tariffs. Finally, in the seventh section we present the major conclusions of the chapter regarding the relationship between governance capacity and economic reform.

Initial Conditions of Fiscal Reform

Political Process and the Changing Vision

The Islamic Jamboori Ittehad (IJI) government that emerged as a coalition of political forces in August 1990 (see political chronology in figure 1) was dominated by the Muslim League, the political party that had played a critical role in the creation of Pakistan under the leadership of Mohammed Ali Jinnah (father of the nation). The IJI consisted of the Muslim League, an essentially secular party, aligned with an assortment of religious parties such as the Jamaat-i-Islami. The major unifying factors were the common opposition to the Pakistan Peoples Party (PPP) led by Benazir Bhutto, and that most of the components of the IJI had been sympathetic to, and nurtured by, the previous martial law regime of General Ziaul Haq. The PPP was in power between 1988 and 1990, but it was removed by dissolution of the Parliament under the powers vested with the president (in the Eighth Amendment to the Constitution made by the military government) on the grounds of ineptitude and corruption.

The change of government in 1990 represented a major realignment of political forces in

Figure 1

Political Chronology of Pakistan

1971  Breakaway of the east wing of Pakistan
      Induction of the Pakistan Peoples Party (PPP) government of Zulfiqar Ali Bhutto

1977  Coup d'état by the military
      Installation of martial law government under General Ziaul Haq

1985  Partial transition to civilian government following constitutional amendments
      Formation of a nonparty government with Mohammad Ali Khan Junejo as prime minister

1988  Sacking of the Junejo government by the president (General Ziaul Haq)
      Assassination of General Ziaul Haq
      General elections, followed by formation of PPP government with Benazir Bhutto as prime minister

1990  Sacking of the PPP government by the president (Ghulam Ishaque)
      General election, with IJI emerging as winner
      Government formed with Nawaz Sharif as prime minister

1993  Dissolution of the Nawaz Sharif government
      Reinstatement of Nawaz Sharif government following Supreme Court judgment
      Dissolution of Nawaz Sharif government
      General elections leading to formation of government with Benazir Bhutto as prime minister.

1  Caretaker governments were established on a temporary basis.
the country. During the decade of the 1970s, Pakistan had adopted the path of socialism through large-scale nationalization of industry and banking and a major expansion of the public sector role in the first PPP government of Zulfiqar Ali Bhutto (father of Benazir Bhutto). This was primarily a response to worsening regional and personal income disparities associated with the capitalist development of the 1960s that led to the breakup of the country.

The military coup of 1977 did arrest some of these developments, but there continued to be a commitment to a highly regulated economy and dominance of the public sector. The shock of nationalization led to a major retreat of the private sector, and private investment remained heavily depressed for many years. By the mid-1980s there was growing disillusionment with the inherent problems of inefficiency and corruption in the public sector. Industrial growth stagnated, affecting the overall dynamism of the economy. The Junejo government (from 1985 to 1988) and the Bhutto government (from 1988 to 1990) took some tentative steps toward liberalization and deregulation of the economy.

The emergence of Nawaz Sharif as the prime minister in 1990 signaled the reemergence (after the Ayub Khan era in the 1960s) of capitalist forces in the country. Himself a leading businessman, Mr. Sharif was able to portray the image of an agent of change involved in dismantling the overgrown public sector through privatization and deregulation and restoring the role of the private sector as the "engine of growth." Mr. Sharif moved with great vigor and dynamism. A number of industrial enterprises and financial institutions were sold back to private entrepreneurs. There was extensive deregulation, including that of the trade and foreign exchange regime. The financial sector was liberalized, and numerous fiscal incentives were offered to private investment, along with simplification of procedures.

The overall vision was a rapid transformation from a highly regulated to a market economy to fully unleash the creative energies of the private sector. In the initial period, Mr. Sharif was successful in projecting this vision of change. The stock market soared, and there was a quantum jump in private investment; the economy once again showed some dynamism. Economic reforms during the period in general, and fiscal reforms in particular, are to be viewed in the context of this vision, which involved a shift toward the market economy, minimization of the role of the public sector, and the creation of an environment conducive to the growth of the private sector.

The Nawaz Sharif government saw fiscal reforms not only as a means of correcting macroeconomic imbalances (especially the large budget deficit), but also as a way to facilitate growth through large-scale investments in physical infrastructure (especially transport and communications and energy) to support higher private sector investments in industry. There was a widespread perception of defects in the tax system and a failure of tax administration, which had acted as a barrier to the conduct of private economic activities through the presence of complex and opaque tax laws, harassment by tax officials, and large-scale corruption and evasion.

As part of his economic reform program, within three months of the formation of his government, Mr. Sharif announced the appointment of a high-powered Tax Reforms Committee (TRC). It was headed by a senator and included businessmen, professionals (accountants, tax practitioners, lawyers, and the like), senior tax officials, and academics, who were asked to suggest ways to revamp the tax system and make it more transparent, simpler to administer, and more protective of the interests of taxpayers, while simultaneously expanding the revenue base. The Resource Mobilization and Tax Reforms Commission (RMTTRC) was subsequently put in place to implement the recommendations of the TRC and to participate in the budget-making process.
Before we analyze the resulting process of reform, we first characterize the conditions that prevailed when the Nawaz Sharif government came into power.

Process of Economic Reform

The impetus for economic reform in Pakistan has come either from installation of a political government with a new vision or ideology about the role of government and the strategy of economic growth, usually in response to some major underlying structural problem, or following an agreement with international agencies such as the IMF on a plan for structural adjustment, along with an increased inflow of funds. We have discussed the former in the previous section, and focus on the latter here.

The first major structural adjustment program in Pakistan covered the period from 1980 to 1985. Policy areas in this program included agriculture, with emphasis on removal of the fertilizer subsidy, a proper relationship between world and domestic prices, and an increase in irrigation water charges. Changes in industrial and trade policy involved price adjustments and management reforms of public industrial enterprises to convert losses into profits, relaxation of controls and streamlining of procedures for investment, and removal of quantitative restrictions on imports along with tariff reductions. In the area of development planning, rationalization of public investments was emphasized. The program was largely a failure, with either no progress or only limited achievement on the various fronts.

The next structural adjustment program, part of the agreement with IMF, was undertaken during the period 1988–93. It included explicit targets, such as reduction of the budget deficit to 5 percent of GDP, with a specific target for containment of federal and provincial government expenditure to between 25 percent and 26 percent of GDP. The current account deficit was to be re-

<table>
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<th>Table 1</th>
<th>Major Macroeconomic Indicators for Pakistan</th>
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<tr>
<td>Percent</td>
<td>GDP growth rate</td>
</tr>
<tr>
<td>1980–81</td>
<td>6.4</td>
</tr>
<tr>
<td>1981–82</td>
<td>7.6</td>
</tr>
<tr>
<td>1982–83</td>
<td>6.8</td>
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<td>1991–92</td>
<td>7.7</td>
</tr>
<tr>
<td>1992–93</td>
<td>2.2</td>
</tr>
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</table>

Source: Pakistan Economic Survey.
duced to 2.6 percent of GDP, and foreign exchange reserves raised to at least six weeks of imports. The target for the rate of inflation was 6 percent. Specific policy initiatives included tariff reforms, financial sector liberalization, and auction of public debt. In the achievement of the major targets, this program was not a success. The budget deficit exceeded 6.5 percent every year, the current account deficit averaged 4.7 percent of GDP, and the inflation rate remained at about 10 percent a year during the period (see table 1). Policy changes were implemented. The maximum tariff was reduced from 225 percent to 95 percent, the process of the auction of treasury bills was started, interest rates on concessionary credit schemes were raised somewhat, two nationalized banks were privatized, and ten new private commercial banks were established.

Altogether, Pakistan does not appear to have an enviable record in implementing structural adjustment programs.

State of Public Finances

The problem of major structural imbalances in the public finances of the country had been visible since the mid-1970s. Over the fourteen-year period from 1977–78 to 1990–91, the consolidated budget deficit of the federal and provincial governments combined had been in excess of 6 percent of GDP in twelve years (see table 2). During the mid-1980s, the major source of financing of the budget deficit was domestic nonbank borrowing (see table 3), which consisted primarily of the inflow of funds into voluntary savings schemes with relatively attractive real rates of return. This had depressed the development of the capital market and financial intermediation in the economy. Next in importance were external borrowings, largely on a concessional basis from bilateral and multilateral donors. The monetized component of the budget deficit, consisting of bank borrowing, was relatively small. This implied that large budget deficits were not accompanied by inflation, which generally remained at a single-digit rate. In the event that there was a large, unanticipated increase in the budget deficit, however, as happened in 1990–91 because of the Gulf War, bank borrowing represented the residual source of financing.

The record budget deficit in 1990–91 (primarily the result of the rise in oil prices, which reduced revenues from the petroleum development surcharge and import duties, while at the same time necessitating a larger subsidy to oil refineries), on the eve of a change in government, and the resulting rise in the rate of inflation to the two-digit level (12 percent) for the first time in twelve years greatly increased perceptions of a budgetary problem. Years of a sustained high level of borrowing had led to a very rapid growth in the cost of debt service. Historically, development and defense expenditures were the largest claimants to public resources. But by 1990–91, debt service had reached the same order of magnitude. The Nawaz Sharif government (and governments thereafter) attributed the budgetary problem primarily to financial profligacy on the part of previous governments, which had led to rapid accumulation of public debt and a concomitant increase in servicing costs; an inefficient and overgrown public sector that had displaced the private sector, even in directly productive activities; and an inadequate level of resource mobilization, primarily the result of rampant evasion and corruption. It is surprising that in the Pakistani setting there is very little recognition of the burden imposed by high defense expenditures (over 6 percent of GDP). Popu-

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1 Excluding local governments, which account for a minor portion, less than 5 percent, of total public expenditure in Pakistan. Because of a lack of support from higher levels of government and legislative constraints to borrowing, these governments generally have to balance their budgets from their own revenues.
Table 2
National Budget Deficit of Pakistan, 1977–78 to 1992–93
Percentage of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>Total revenue</th>
<th>Tax revenue without surcharges</th>
<th>Surcharges</th>
<th>Nontax revenue</th>
<th>Total expenditure</th>
<th>Current expenditure</th>
<th>Development expenditure</th>
<th>Budget deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977–78</td>
<td>15.0</td>
<td>11.9</td>
<td>0.3</td>
<td>3.1</td>
<td>23.2</td>
<td>14.5</td>
<td>8.7</td>
<td>7.9</td>
</tr>
<tr>
<td>1978–79</td>
<td>15.7</td>
<td>12.6</td>
<td>0.3</td>
<td>3.3</td>
<td>25.1</td>
<td>15.6</td>
<td>9.5</td>
<td>8.9</td>
</tr>
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<td>1979–80</td>
<td>16.4</td>
<td>13.7</td>
<td>0.3</td>
<td>3.1</td>
<td>23.3</td>
<td>14.0</td>
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<td>6.3</td>
</tr>
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<td>1980–81</td>
<td>16.9</td>
<td>13.5</td>
<td>0.5</td>
<td>3.6</td>
<td>22.9</td>
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<td>25.9</td>
<td>19.5</td>
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a. Taxes collected by the Central Board of Revenue.
b. On petroleum and gas.
c. Including self-financing by autonomous corporations.

Table 3
Financing the Budget Deficit in Pakistan, 1985–86 to 1992–93
Percentage of budget deficit financed

<table>
<thead>
<tr>
<th>Year</th>
<th>Budget deficit (% of GDP)</th>
<th>External borrowing and grants (net)</th>
<th>Internal nonbank borrowing</th>
<th>Internal bank borrowing</th>
<th>Total</th>
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<td>21</td>
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<td>59</td>
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<td>100</td>
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<td>1987–88</td>
<td>8.5</td>
<td>22</td>
<td>54</td>
<td>24</td>
<td>100</td>
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<tr>
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<td>7.4</td>
<td>32</td>
<td>67</td>
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<td>100</td>
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<td>1989–90</td>
<td>6.5</td>
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<td>53</td>
<td>6</td>
<td>100</td>
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<td>1990–91</td>
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<td>48</td>
<td>100</td>
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<tr>
<td>1991–92</td>
<td>7.5</td>
<td>20</td>
<td>27</td>
<td>48</td>
<td>100</td>
</tr>
<tr>
<td>1992–93</td>
<td>7.9</td>
<td>23</td>
<td>19</td>
<td>58</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Pakistan Economic Survey.
lar perceptions of the budgetary problem generally coincide with the government view. There are, however, stronger expressions of discontent with extravagance in government spending and losses to the public exchequer from tax concessions offered to favored social groups such as landlords (in the absence of a tax on agricultural incomes).

Revenues

The predominant share (almost 90 percent) of revenues is collected by the federal government in Pakistan. This is primarily a reflection of the skewed distribution of the constitutional allocation of fiscal powers in the country, whereby most of the taxes with large and buoyant tax bases—such as income tax, customs duties, excise duties, sales taxes, and the like—lie in the federal domain. Within nontax revenues, the share of provincial governments is somewhat higher, because they are primarily responsible for delivery of economic and social services such as irrigation, education, and health, which are partly financed by user charges. Altogether, tax revenues are the principal source of revenue, with a share approaching 80 percent. The importance of nontax revenues has declined in recent years for three reasons. First, the ongoing process of privatization has reduced the flow of profits and dividend income from state enterprises. Second, profitable entities such as the Telephones and Telegraphs Department have been converted into autonomous corporations outside the budget. Third, there has been a sizable decline in state trading profits from exports.

Within federal tax revenues, there is heavy dependence on indirect taxes. In 1990–91, the

<table>
<thead>
<tr>
<th>Table 4</th>
<th>Level and Composition of Tax Revenues in Developing Countries and in Pakistan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>Percentage of GDP</td>
</tr>
<tr>
<td></td>
<td>Per capita income of less than $360</td>
</tr>
<tr>
<td>Direct taxes</td>
<td>3.91</td>
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<tr>
<td>Income tax</td>
<td>3.27</td>
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<tr>
<td>Wealth and property tax</td>
<td>0.24</td>
</tr>
<tr>
<td>Social Security taxes</td>
<td>0.21</td>
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<tr>
<td>Other</td>
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<tr>
<td>Indirect taxes (domestic)</td>
<td>4.55</td>
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<td>Sales, turnover, VAT</td>
<td>2.44</td>
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<td>Excise</td>
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<td>Other</td>
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<td>Indirect taxes (foreign)</td>
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<td>Import duties</td>
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<td>Export duties</td>
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<td>Other</td>
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<tr>
<td>Other</td>
<td>0.26</td>
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<tr>
<td>Total taxes</td>
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</table>

² Inclusive of surcharges.
share of direct taxes (income tax, wealth tax, and capital value tax) was very low, less than 14 percent. This highlights the imbalance in the tax system of Pakistan. The average share of direct taxes in countries at a comparable level of development was 35 percent in 1989–90 (see table 4). Reasons for the low collections from direct taxes (less than 2 percent of GDP) are to be found in a narrow tax base (created by widespread exemptions and concessions), poor quality of tax administration, and rampant tax evasion. Within direct taxes, the corporate component accounts for over 86 percent. As a whole, income taxes in Pakistan have been largely restricted to corporate profits and salary income (through deduction at source by employers), large publicly quoted companies and multinationals, and taxpayers living in the metropolitan areas.

The primary contribution to indirect taxes is by taxes on international trade, which include a number of levies such as the import duty, export duty, surcharges, and sales taxes. It is estimated that in 1990–91 almost 50 percent of tax revenues originated from taxes levied at the point of entry, or exit from, the country. This reliance can be attributed first to the ease and convenience of collection at the import stage, and second to an import substitution strategy of industrialization that relies on high levels of protection. Sales tax is levied at a uniform rate (12.5 percent in 1990–91) at the import and manufacturing stages, and it includes tax-invoicing features of VAT to avoid cascading of the tax burden. Excise duties are used in a selective manner to discourage consumption of goods such as cigarettes, beverages, petroleum products, and the like.

As highlighted earlier, the salient feature of Pakistan’s taxation system in the late 1980s was relatively high tax rates with narrow tax bases. The latter is the result of wide-ranging exemptions, concessions, rebates, tax credits, and so forth, which have mitigated against neutrality of the system and have tended to create major distortions in the allocation of resources in the economy. The exemption limit of personal income from tax in 1990–91 was Rs 40,000, equivalent to about four times the per capita income. Agricultural income enjoys a special exemption. In addition, various kinds of capital income are outside the tax net, including profits of companies established in backward areas and in designated industries, capital gains on financial assets, interest income from government savings schemes, and special accounts with commercial banks (for example, nonresident rupee accounts). In addition, there is provision for accelerated depreciation allowances for new investment, and tax credits for balancing and modernization. A special rebate has been granted on export income. On top of all this, there is a plethora of targeted exemptions embodied in the Second Schedule of the Income Tax Ordinance related to allowances as part of the remuneration package, pensions, charitable contributions, income of trusts and foundations, income of designated companies, and the like. Some of the largest public sector corporations, including the Water and Power Development Authority (WAPDA), the Karachi Electricity Supply Corporation (KESC), and the State Life Insurance Corporation (SLIC), have statutory exemptions of net income.

The tax base of the wealth tax has also been severely eroded by exemptions. These include a general exemption on assets worth up to Rs 1 million; effective exemption of agricultural lands and owner-occupied property, irrespective of value; and exclusion of financial assets on which the Islamic tax, the Zakat, has already been collected.

Exemptions and concessions are also pervasive in import duties. An effort has been made to ameliorate high tariffs through selective exemptions. A large number of Statutory Rules and Orders (SROs) have been promulgated prescribing special tax treatment by category of commodity and importer. Industrial importers enjoy concessionary rates in comparison with commercial importers. Large public sector importers
are given favored treatment over the private sector. Imports of machinery for backward areas have been granted exemption from customs duty. In addition, imports for essential consumption (such as foodstuffs and drugs), agricultural production (fertilizer, pesticides), defense needs, and the social sectors (such as hospital equipment) are exempt. With the increase in SROs over time, the import duty regime has ceased to be transparent and has become very complex to administer, with ample scope for misdeclaration and corruption.

All items are exempted from excise duties unless specifically declared as excisable. Consequently, only thirty-four industries pay excise duties, but this list includes some of the major industries, such as cement, sugar, tobacco, cotton yarn, beverages, and so forth. The most important exclusion from sales tax is the wholesale and retail trade sector. In addition, basic food items and other essential goods and services do not carry a sales tax.

Given the dependence on indirect taxes and the wide variation of tax incidence on different kinds of income and sectors of the economy, there is a widespread perception of inequity in the distribution of the tax burden between rural and urban areas, between labor income and capital income, between the corporate sector and the informal sector, among households at different income levels, and among different parts of the country. This perception has created problems in the voluntary compliance of taxpayers.

Expenditures

The distribution of public expenditures to different levels of government is more balanced than revenues. This balance has been made possible by an elaborate scheme of revenue-sharing between federal and the provincial governments (discussed in a subsequent section). In 1990–91, 68 percent and 70 percent of current and development expenditure, respectively, were incurred by the federal government; 29 percent and 22 percent, respectively, by the four provincial governments combined; and the remainder by local governments. Within public expenditure, the share of current expenditure has been increasing, while that of development expenditure has fallen.

Major categories of public expenditure are given in table 5. In 1990–91, the largest single claimant of public resources was defense expenditure, with a share approaching 25 percent. Next in importance are interest payments on domestic and foreign debt (17 percent). This is the fastest growing item in expenditures, and it reflects the persistently high budget deficits. Other major categories of expenditure are economic services (22 percent), with large development outlays in sectors such as fuel and power (9 percent), transport and communications (4 percent), and irrigation (4 percent). The overall share of the social sectors is low, at 14 percent, with 9 percent for education and 3 percent for health. This partly explains Pakistan's extremely poor performance in social indicators such as literacy, life expectancy, and infant mortality. The share of public administration is 9 percent, and it has shown a tendency to increase over time.

According to estimates made by the World Bank for 1989–90, current expenditure is about three times the level of development expenditure (see table 6). The share of development expenditure is relatively high in economic services and community services. Current expenditure dominates allocations to social services, defense, public administration, and the like. The Constitution prescribes the allocation of functions between the federal and provincial government whereby the former plays a dominant role in defense, interest payments, subsidies, and economic services. The share of expenditure on public administration by the two levels of government is roughly equal (see table 7), although provincial governments have a more important role in the provision of social and community services. Altogether, the federal government provides national public goods such
as defense and performs more of a redistributive function through transfer payments and subsidies while discharging debt obligations. Provincial governments have traditionally supported agricultural operations and rural development, and in more recent years they have engaged in subsidized provision of social services such as primary education and curative health, especially in the rural areas. Provision of such services has increasingly become the responsibility of local governments and the private sector in larger cities.

Subsidies have largely been targeted at agricultural inputs (such as fertilizer) and urban consumption of such basic commodities as wheat, sugar, kerosene oil, and edible oil (see table 8).

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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td></td>
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</table>

a. Revised estimate.
c. Mostly physical planning, housing, and public health.

With the expansion of public sector operations, however, the government has had to pick up losses of large industrial enterprises (such as The Steel Mill) and those incurred in state trading (export of cotton, for example).

Following the process of Islamization in Pakistan in the late 1970s, state involvement in social welfare activities increased. Revenues from the Islamic tax on assets, Zakat, have poured into a dedicated fund (managed by a board headed by an administrator) outside the budget and are used largely for income supplements to the mustaqeen (the poor). The fund is sizable, over Rs 3 billion, and it has grown over time, although there are increasing perceptions of misuse and leakage in the targeting and distribution of funds.

Table 6
Share of Current and Development Expenditure in Total Public Expenditure in Pakistan, 1989–90

<table>
<thead>
<tr>
<th>Category</th>
<th>Total expenditure (Rs million, 1980–81 prices)</th>
<th>Percentage share</th>
</tr>
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<tr>
<td></td>
<td></td>
<td>Current</td>
</tr>
<tr>
<td>Public administration</td>
<td>10,952</td>
<td>100</td>
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<td>General administration</td>
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<td>Law and order</td>
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<td>Defense</td>
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<td>Social services</td>
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<td>Other</td>
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<tr>
<td>Total expenditure</td>
<td>130,256</td>
<td>76</td>
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</table>

The rural equivalent of Zakat is the Ushr, which is collected on agricultural production. Revenues from this tax are earmarked for distribution at the local level. Collections are very small. More recently a Bait-ul-Maal (a special Islamic social welfare fund) was established to fund the dowries of brides, support orphans, and so forth.

Along with the fiscal subventions, there are significant government interventions with credit through the financial system. Concessionary credit (share of over 30 percent in total credit) has been provided to promote exports and locally fabricated machinery, while mandatory targets have been established for loans to socially preferred sectors such as agriculture, small-scale business, and housing, either through the commercial banks or specialized public sector financial institutions such as the Agricultural Development Bank of Pakistan (ADBP), the Industrial Development Bank of Pakistan (IDBP), and the House Building Finance Corporation (HBFC). Significant rent-seeking activity has developed around access to subsidized credit, and there are general complaints of siphoning off of funds, mistargeting, and corruption.

### Table 7

<table>
<thead>
<tr>
<th>Category</th>
<th>Federal</th>
<th>Provincial</th>
<th>Total</th>
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<tbody>
<tr>
<td>Public administration</td>
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<td>46</td>
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<tr>
<td>General administration</td>
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<tr>
<td>Law and order</td>
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<td>Defense</td>
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<tr>
<td>Health</td>
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<td>81</td>
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</tr>
<tr>
<td>Other</td>
<td>80</td>
<td>20</td>
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<tr>
<td>Economic services</td>
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<td>Agriculture</td>
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<tr>
<td>Irrigation</td>
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<tr>
<td>Industries and minerals</td>
<td>48</td>
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</tr>
<tr>
<td>Works</td>
<td>6</td>
<td>84</td>
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</tr>
<tr>
<td>Transport and communications</td>
<td>42</td>
<td>58</td>
<td>100</td>
</tr>
<tr>
<td>Fuel and power</td>
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<td>100</td>
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<tr>
<td>Other</td>
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<td>37</td>
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<tr>
<td>Community services</td>
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<tr>
<td>Other</td>
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<tr>
<td>Interest payments</td>
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<td>Other</td>
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<tr>
<td>Total expenditure</td>
<td>70</td>
<td>30</td>
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</table>


### Institutional Setting for Budget-Making

The conventional practice in Pakistan in the formulation of expenditure budgets is based on the "bottom-up" demands of government ministries, departments, and agencies. A ceiling is imposed on these demands by the Ministry of Finance at the federal level, based on projected revenues and the acceptable level of budget deficit. Public expenditures in the current expenditure and development expenditure areas involve different procedures and are subject to a variety of criteria.

The fiscal year in Pakistan is from July 1 to June 30. Estimates of current expenditures are prepared by the ministries in two parts. The first part relates to ordinary expenditures, which include standing charges such as establishment, travel allowance, and contingent expenditure. These expenditures do not vary much from year to year, and they are expected to be provided on a regular basis. The second part contains expenditure areas that are discretionary in character, and can show sizable fluctuation depending upon availability of funds. Demands for expenditures of this kind are generally subject to greater scrutiny than ordinary expenditures.

The Budget Wing of the Ministry of Finance plays the leading role in the formulation of budget estimates. Preparation of the revised estimates
Table 8

<table>
<thead>
<tr>
<th></th>
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<tr>
<td>Total (Rs billion)</td>
<td>8.1</td>
<td>6.9</td>
<td>10.1</td>
<td>15.7</td>
<td>10.2</td>
<td>11.5</td>
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<td>Wheat and sugar</td>
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<td>46</td>
<td>44</td>
<td>38</td>
<td>45</td>
<td>57</td>
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<tr>
<td>Edible oil</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>18</td>
<td>–</td>
<td>19</td>
<td>–</td>
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<tr>
<td>Losses, Cotton Export Corporation</td>
<td>–</td>
<td>22</td>
<td>19</td>
<td>–</td>
<td>25</td>
<td>1</td>
<td>–</td>
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<tr>
<td>Pakistan Steel Mill</td>
<td>1</td>
<td>20</td>
<td>12</td>
<td>15</td>
<td>–</td>
<td>11</td>
<td>18</td>
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<tr>
<td>KESC</td>
<td>–</td>
<td>–</td>
<td>1</td>
<td>3</td>
<td>–</td>
<td>13</td>
<td>–</td>
<td>7</td>
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<tr>
<td>Fertilizer</td>
<td>30</td>
<td>16</td>
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<td>15</td>
<td>11</td>
<td>12</td>
<td>11</td>
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<td>3</td>
<td>20</td>
<td>6</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Pakistan Economic Survey.

Each year precedes the preparation of budget estimates. If revised estimates exceed the sanctioned budget, there is a need to indicate the source of extra funding from among reappropriation, savings, or a supplemental grant. Budget estimates for the next year are generally based on an incremental approach.

The budgetary process in Pakistan has been gradually decentralized through the appointment of financial advisers in each ministry. These officials are competent to approve budget estimates on behalf of the Ministry of Finance. Incremental budgeting has, however, created a tendency to inflate the initial requests and the base level of expenditure.

With regard to development expenditure, each year sponsoring agencies present a list of approved projects, some ongoing and others new. The larger the project, the more stages will be involved in the approval process. The divergence between demands and development resources is resolved by the Inter-Ministerial Priorities Committee, chaired by a senior official of the Ministry of Finance, on the basis of a given set of priorities.

There has been a long-standing tendency to exceed budgeted levels of current expenditure and to underspend on the development account. In general, there has been an erosion in budgetary discipline in Pakistan. The budget monitoring and control functions of the Ministry of Finance have been rendered largely ineffective. Public funds have frequently been used for patronage by elected representatives. Pet projects have received priority in funding, without obtaining proper prior approval. The development program is too thinly spread among a large number of ongoing schemes, leading to long delays in implementation and sizable cost overruns.

Defense expenditure has generally been accorded the highest priority in budget allocations. The defense budget is approved by Parliament without access to any breakdowns of expenditure or any evaluation of cost effectiveness. The overall salary and allowance component is also protected, and redundancies in the public sector are very uncommon. In the presence of a budget constraint, allocations for the social sectors and nonsalary areas are generally the first to be scaled down.

Budgets must generally be passed by Parliament prior to the beginning of the fiscal year. Elected representatives seldom focus on the
broader macroeconomic issues or intersectoral priorities, and they tend to promote only their own favorite schemes or the development of their individual constituencies. Given the poor quality of debate and the low level of accountability, the executive has gotten its programs passed largely by default. Major ad hoc enhancements or reallocations in expenditure are made without recourse to supplementary budgets, and SROs granting tax concessions are promulgated without seeking legislative approval.

Accounting systems are primitive, and there have been no major innovations in financial management since the British Raj. There are long lags in reporting of expenditures, which precludes timely intervention. No mechanism has been developed to monitor the execution of projects on a regular basis. Auditing procedures are slow and cumbersome, and they have proved to be unsuccessful in combating inefficiency and corruption.

In addition, the Central Bank has tended to become subservient to the dictates of the Ministry of Finance. The consequence is that monetary policy has largely adopted an accommodative stance to the growing borrowing needs of government. Levels of deficit financing have been high, especially in recent years, and have fueled inflation. Altogether, the decline in the quality of governance is vividly manifested in the failure to effectively discharge the financial function.

**Intergovernmental Fiscal Relations**

Fiscal federalism in Pakistan has been characterized by the extreme dependence of provincial governments on the federal government (see table 9). The imbalance between allocation of fiscal powers and functions created a need for elaborate revenue-sharing arrangements. Decisions regarding which taxes should form part of the divisible pool and the formula for the distribution of revenues between the federation and each province are made by the National Finance Commission (NFC) under the instructions of the president. The NFC is expected to make a new revenue-sharing award every five years, but the last award remained valid for seventeen years (up to 1991) because of a deadlock among provinces on the revenue-sharing formula. According to this award, major taxes in the divisible pool were the income tax and the sales tax, with 80 percent of revenues (net of costs of collection) going to the provinces, to be shared on the basis of population. This award had proved to be inadequate to finance the growing expenditure needs of the provincial governments, and ad hoc arrangements were needed that required the federal government to take on additional functions (universities, flood control, waterlogging and salinity projects, highways, and the like) and to make special grants to pick up any residual deficits. This promoted profligacy in expenditure and slackening of fiscal effort on the part of provincial governments. The NFC award of 1991 substantially expanded the divisible pool, linked revenue-sharing more closely to collection (see table 10), and eliminated deficit grants. Fixed special grants, however, have been instituted for a limited period.

Contrary to the practice elsewhere, fiscal transfers (revenue-sharing or grants) from provincial governments or the federal government to the local governments are very limited. Provincial governments generally prefer to engage in direct provision of municipal services, such as water supply and sanitation, primary education, health, and the like, rather than hand over resources to local governments. This is motivated by considerations of political patronage and the limited institutional capability of most local governments to deliver services. This has tended to break the link between taxation and benefits, and has reduced accountability in service provision, while stunting the growth of representative local institutions in the country.

**Tax Administration**

At the federal level, tax collection responsibility rests primarily with the Central Board of Revenue (CBR). This is a department of the Ministry of
Finance (now upgraded to the Revenue Division), and it has separate cadres of tax officials for income and wealth taxes, customs, sales taxes, and excise taxes. The collection of income tax is administered through zones and circles, while there are collectorates in the case of indirect taxes. A pivotal position in income tax administration is occupied by the Income Tax Office; it is, however, a relatively junior office in the hierarchy. The Income Tax Office is responsible for assessing returns and raising demands, and it has considerable discretionary power. Even large, publicly quoted companies and multinationals are initially assessed by these junior functionaries, who hold no specialized expertise. The excise system operates on the basis of supervised clearance, and individual factories have resident excise inspectors. Customs staff are available at all points of entry of goods into Pakistan, and they generally perform on-site inspection of consignments. The sales tax system, however, operates differently, based largely on self-assessment by the taxpayer with random checks by the department.

Costs of collection are low: 3 percent in the case of direct taxes, and less than 1 percent for indirect taxes. This is, however, not a reflection of high levels of efficiency, but of the low priority traditionally attached to tax administration.
There is chronic understaffing, support facilities are absent, and no major investment had been made in improvements such as computerization up to 1990–91.

Symbols of corruption in the popular culture are the Income Tax Office, the customs preventive officer, and the excise inspector. Despite being junior positions, they carry considerable patronage, and individuals are frequently recommended for appointment by senior and powerful politicians. Tax evasion—either with the connivance of these officials or otherwise—has become a way of life. Application of the tax code is largely restricted to corporate and salaried taxpayers. Self-assessment schemes, with relatively low probability of audit, have been put in place by the income tax department to assist taxpayers with relatively small incomes (up to Rs 200,000 annually) who are essentially self-employed and do not maintain detailed accounts. Similarly, the excise and sales tax acts are not very strictly enforced in the case of small-scale industrial units, which frequently either enjoy exemption or pay fixed taxes (no link with production) only.

Transparency, Accountability, and Controls

The general characterization of the pattern of governance at all levels of government and within most departments is one of a general lack of transparency in rules and regulations and a virtual absence of accountability. Most agencies are supply-driven. The lack of transparency reinforces bureaucratic power, increases discretion, and allows the intrusion of increased bribery and corruption. In the context of tax administration, we have examples of large import duty savings that can be realized through changes in commodity classification or the use of some obscure SRO for granting exemptions. Similarly, the absence of proper yardsticks and procedures for assessment enables Income Tax Offices to behave arbitrarily and to extract a price for a favorable assessment. Given the day-to-day contact of excise inspectors with factory owners or management, it is not surprising that side deals are struck for releasing consignments from the premises without payment of tax.

Main Beneficiaries of Fiscal Arrangements

The main beneficiaries of fiscal arrangements are groups that can either reduce their tax payments—by obtaining exemptions/concessions and favored treatment in the assessment process from the tax department—or get higher transfer payments or subsidies. The most commonly quoted examples of privileged treatment are owners of agricultural land and personnel of the armed forces. The former do not pay income tax, receive concessional credit, have access to subsidized inputs such as fertilizer and irrigation water, and benefit directly from development allocations, especially from the provincial governments. The defense budget is sacred, and it receives top priority, even in times of financial stringency. Consequently, salary and fringe benefits of defense personnel are higher and more secure than those of others. The economic power of these groups is a reflection of their privileged political status. The military has had a major role in governance in Pakistan, either directly or indirectly. The traditional feudal elite has regularly captured a very large share of the seats in the Parliament because of their control over rural votes.

Other beneficiaries are those self-employed in the informal sector, engaged in activities such as trading, transport, and miscellaneous services. The income tax code is not so strictly enforced here, and the possibilities of successful underdeclaration are great. Small-scale industrial establishments also enjoy special exemptions or favored treatment in the collection of indirect taxes, although they are at a disadvantage in access to imported raw materials, credit, and infrastructure (for example, power). Recipients of capital income also face a lower tax burden because of exemp-
tions, less likelihood of detection, and benefit from the general view of government that such income should be encouraged to promote the process of capital formation in the country.

**Imperatives for Tax Reform**

**Fiscal Imbalance**

Large budget deficits had become a chronic problem in Pakistan. This had led to very rapid growth in the debt-servicing burden; along with defense expenditure, it had become the largest claimant on public resources. The first year of the IJI government was an exceptionally bad one, largely because of the adverse effects of the Gulf War, and the budget deficit (in 1990-91) reached a peak of almost 9 percent of GDP. The government, which was strongly committed to the vision of a process of investment and growth led by the private sector, was concerned that large budget deficits would not only crowd out the private sector, but would also make it impossible to embark on the major public investments in physical infrastructure—such as motorways, ports, power plants, and the like—needed to remove constraints to growth.

During the 1980s, much of adjustment had been through decline in development expenditures, which fell from about 9.5 percent of GDP in 1978-79 to about 6.5 percent by 1990-91. This had led to postponement of maintenance expenditures on public assets such as the vast irrigation system, the network of roads, and the electricity transmission and distribution system. Simultaneously, expenditures on social sectors had to be restricted, which implied slow progress in Pakistan’s already poor human development indicators. Clearly, it was not possible to achieve further cutbacks in public development expenditures.

The strategy of budget deficit reduction required action in both the current expenditure and resource mobilization. Scope for reduction in the former was limited by downward rigidities in debt-servicing and defense expenditure. Debt-servicing had grown very rapidly (doubling every four years) in the face of large and persistent budget deficits and the rising marginal costs of public sector borrowing following financial sector liberalization. The only prospect for significant cost saving was debt retirement with the proceeds of privatization. It was necessary to limit real growth in defense spending by improving cost effectiveness. Simultaneously, the Nawaz Sharif government assembled the Economy Commission to identify scope for expenditure cuts in wages and salaries of the ministries, departments, and semiautonomous organizations. The commission’s proposals have proved difficult to implement, however, because of the political difficulty of achieving large-scale retrenchments of employment in the public sector. It was clear that the major element in correcting the budget deficit would have to be resource mobilization, particularly development of the tax system.

**Low Level of Resource Mobilization**

Government revenues have tended to stagnate as a percentage of GDP. Tax revenues have generally ranged from 13 to 14 percent of GDP, which is low compared with tax revenues of other countries at a comparable stage of development, which average about 19 percent (see table 4). This low level was maintained despite a period of rapid economic growth (approaching 6 percent annually) in the 1980s, and rapid expansion in such tax bases as industrial production and imports. Pakistan had an unrepresentative military government for most of the period that was actively engaged in supporting the freedom struggle in neighboring Afghanistan.
During this period concessional foreign aid flowed in freely, and there was exponential growth in home remittances by Pakistanis working abroad (primarily in the Middle East). The military government chose to give tax breaks to promote a veritable consumption boom in the country, and thus keep the populace content. Given the ready availability of foreign and domestic savings to finance budget deficits, there was little realization of the underlying structural problem of public finances. Consequently, the tax-to-GDP ratio stagnated, and there was little fiscal effort, even in the presence of large budget deficits. This strategy became unsustainable as the foreign aid environment changed and the load of debt servicing became increasingly heavy. The government felt that there was considerable scope for incremental resource mobilization to solve the budgetary problem, given the low tax-to-GDP ratio.

**Economic Distortions**

A series of major economic distortions resulting from the policy of high tax rates on narrow tax bases had become visible. The nonneutrality of the tax system mitigated against an efficient allocation of resources in the economy. High rates of corporate taxation compared with personal income tax rates discouraged incorporation of businesses and created a strong preference for debt financing (interest payments are tax deductible) over equity financing. Wide-ranging exemptions of capital income encouraged speculative investments in real estate and short-term participation in the stock market. Tax rate differentials by firm size promoted fragmentation of units and loss of potential economies of scale. Fiscal incentives for investment in backward areas led to suboptimal choices of locations from the viewpoint of minimization of economic costs. Consumption choices were manipulated, especially by the favored treatment of perquisites in kind such as housing, transport, and the like.

The presence of high tariff walls gave excessive protection to domestic industry and permitted survival of many inefficient activities (with negative value added at world prices), created an anti-export bias, and induced large-scale smuggling into the country (almost 5 percent of GDP, according to some estimates). Altogether, there was a growing realization that the tax system was not conducive to the conduct of efficient economic activities by the private sector, and that if deadweight losses were minimized, there could be significant gains in national income.

**Lack of Elasticity of the Tax System**

One of the reasons for the lack of increase in the tax revenue/GDP ratio was the low elasticity of the tax system. For federal taxes as a whole, this has been estimated at about 0.8. This implies that in the absence of any tax rate changes or improved tax administration, a 1 percent increase in GDP is accompanied by a 0.8 percent increase in tax revenues. Elasticity of income tax and excise duty is estimated at below unity, while it is close to unity for customs duty and significantly above 1 for sales tax.

The low elasticity of excise duties is attributable to the specific (and not ad valorem) character of the tax rates and that the tax is levied on industries that are basic in nature and have low income elasticities of demand. It is surprising, however, that income tax also has low elasticity. In most countries income tax revenues are relatively buoyant. The inherent reason for this buoyancy is that because the tax structure is progressive, with rising marginal tax rates, revenues from the tax rise disproportionately with the increase in income. This, however, has not happened in Pakistan. The explanation for this is either that the quality of income tax administration is declining over time, or that the tax base is increasingly oriented toward sectors with relatively high levels of tax evasion.

One of the policy goals of tax reform must be to raise the elasticity of the tax system.
so that revenues increase automatically with growth in the economy. This will obviate the need for frequent enhancements in tax rates, which are not only politically costly for elected governments, but also increase disproportionately the deadweight losses associated with taxation.

**Regressivity of Tax Burden**

Research on the tax system of Pakistan has demonstrated the regressivity of the tax burden with respect to the income levels of households. The major reason for this, of course, is the low share of direct taxes in revenues. In addition, the burden of excise duties and import duties is markedly regressive in character, while the incidence of the sales taxes is generally neutral. Therefore, the imperatives of tax reform are to increase the contribution of direct taxes and to move from selective taxation of imported and domestic consumer goods toward broad-based taxation of consumption expenditure through the uniform rate general sales tax (GST).

**Evasion and Corruption**

There is a common perception that the size of the black economy in Pakistan is very large, and growing. One of the main objectives of tax reform thus must be to bring incomes that have remained outside taxation into the tax net. Research commissioned by the RMTRC reveals that in 1989–90 the assessed income for income tax purposes was only 15 percent of GDP. Fifty-two percent of assessed income was from the corporate sector, followed by 43 percent from individuals, and 5 percent from registered firms. The high tax evasion sectors of the economy are small-scale manufacturing, construction, wholesale and retail trade, transport and communications, ownership of dwellings, and services. The combined share of these sectors increased during the 1980s. A recent application by Ahmed (1994) of the monetary approach (adopted by Vito Tanzi 1983) to quantification of the size of the black economy reveals that it was almost 40 percent of GDP in the late 1980s.

A fiscal approach that relies on estimation of potentially assessable income comes to a similar conclusion, with an estimate of the black economy at about 26 percent of GDP. The ratio of assessable to assessed profits was 1.6:1, while the ratio of assessable to assessed wages was 2.4:1, with the overall ratio close to 2:1 in 1989–90. For the large-scale manufacturing sector, the extent of base erosion was 35 percent—20 percent as a result of tax holidays or government ownership, 3 percent from depreciation, and 12 percent because of wages below the income tax limit. The research also reveals considerable underreporting of unearned income such as dividends, rent, interest, and the like in relation to earned income.

The implications for tax reform strategy are that significant revenue gains could be realized if inroads can be made into the black economy through broad-basing of the income tax system, largely through presumptive and withholding taxes.

**Strategy of Fiscal Reform**

Given the structure of the public finances of Pakistan, it is clear that action to remove the fiscal imbalance will have to focus on revenue and curtailment of unproductive expenditures. Within revenues, taxes in particular need to be developed, because nontax revenues will continue to decline with the process of privatization and a shift toward a market economy.

Pakistan’s fiscal effort is revealed to be low when it is placed in the international context. This is especially true of direct taxes, where there is considerable slack. The strategy of fiscal reform will thus need to focus on the development of the income and wealth taxes. This will require development of mechanisms to combat the rampant evasion and corruption in the system, including presumptive and withholding taxes and removal of the large number of tax expenditures. This will not only raise additional
Governance, Leadership, and Communication: Building Constituencies for Economic Reform

revenues, but will also enable a transition to a more neutral, buoyant, and efficient tax system. In the following two sections we analyze the relationship between governance capacity and the degree of success in implementation of these reforms.

Introduction of Withholding, Presumptive, and Fixed Taxes

Degree of Success in Implementation

Withholding taxes have traditionally represented ad hoc deductions at source at the point of accrual of income, with subsequent adjustment following assessment by the tax department of the statement filed of income from all sources. In this sense they have the obvious merit of preventing leakage of income from the tax net. The responsibility to collect withholding taxes is essentially decentralized, however, and there is a possibility of collusion between the withholding tax authority and the taxpayer. There is thus a tendency to restrict the role of the tax collector to government agencies, public corporations, and large companies. Another problem is that if withholding tax rates are set too high, they can create the problem of refunds by the tax department. These refunds are prone to misuse and corruption. Initially there was a tendency to convert withholding taxes into presumptive taxes, representing fixed and final settlement of tax liabilities. The primary objectives were increased simplicity and a reduction in the compliance cost to taxpayers.

Withholding and fixed taxes have primarily been used to extend the coverage of the income tax to various forms of capital and unearned income. Traditionally, Section 50 of the Income Tax Ordinance (ITO), which covers such taxes, was generally restricted to salary income, with deduction at source on a monthly basis by employers. In the initial stage this was extended to cover other forms of income, such as interest income of financial institutions from government securities; income of nonresidents; and income of contractors, suppliers, and importers. From 1991 onward there were significant developments in the withholding/fixed tax regime. In the Finance Act of 1991, a fixed tax at the flat rate of 10 percent was levied on interest income from financial institutions and on dividends, and at 5 percent on property rental income above Rs 100,000. This was followed, in the Finance Act of 1992, with the extension of a fixed tax (at 0.5 percent to 1 percent of value) on exporters, to be collected by the State Bank of Pakistan at the time of realization of foreign exchange proceeds.

Use of withholding/fixed taxes has not remained restricted to deductions at source in Pakistan. These taxes have increasingly been levied at points where it is possible to get a proxy of the income of a taxpayer. This innovation in the tax system is largely attributed to the desire to detect tax evasion. For the first time a withholding tax was levied on commercial and industrial consumers of electricity in the Finance Bill of 1992. The objective was to bring a large number of small to medium-size taxpayers into the income tax net, on the assumption that there is a relationship between electricity consumption and income. The magnitude of the withholding tax was linked progressively to the value of the electricity bill, with collection responsibility resting with the power utilities. A similar concept was applied in 1992 to justify the imposition of a withholding tax at the time of granting and updating the registrations of private motor vehicles, and in 1993, a 5 percent tax at the time of issuance of foreign exchange for travel abroad (withdrawn in 1994), and at the rate of 2 percent of estimated cost at the stages of approval of building plans and issuance of completion certificates to developers.
Table 11
Trend in Revenues from Withholding and Presumptive Income Taxes in Pakistan, 1988–89 to 1992–93
Rs million

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<tbody>
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<td>50/1</td>
<td>Salary</td>
<td>705</td>
<td>930</td>
<td>1,395</td>
<td>1,732</td>
<td>2,431</td>
<td>36.3</td>
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<tr>
<td>50/2</td>
<td>Interest on securities</td>
<td>1,836</td>
<td>1,850</td>
<td>1,673</td>
<td>4,609</td>
<td>7,072</td>
<td>40.0</td>
</tr>
<tr>
<td>50/3</td>
<td>Income of nonresidents</td>
<td>264</td>
<td>232</td>
<td>494</td>
<td>2,077</td>
<td>239</td>
<td>19.5</td>
</tr>
<tr>
<td>50/4</td>
<td>Income from contracts</td>
<td>2,286</td>
<td>2,833</td>
<td>3,822</td>
<td>5,080</td>
<td>6,846</td>
<td>31.5</td>
</tr>
<tr>
<td>50/5</td>
<td>Brokerage fees</td>
<td>931</td>
<td>1,952</td>
<td>2,071</td>
<td>3,039</td>
<td>3,556</td>
<td>39.8</td>
</tr>
<tr>
<td>50/6</td>
<td>Exporters</td>
<td>90</td>
<td>84</td>
<td>139</td>
<td>138</td>
<td>157</td>
<td>14.9</td>
</tr>
<tr>
<td>50/7A</td>
<td>Dividends</td>
<td>90</td>
<td>84</td>
<td>139</td>
<td>138</td>
<td>157</td>
<td>14.9</td>
</tr>
<tr>
<td>50/7B</td>
<td>Rental income</td>
<td>90</td>
<td>84</td>
<td>139</td>
<td>138</td>
<td>157</td>
<td>14.9</td>
</tr>
<tr>
<td>50/7C</td>
<td>Winnings from lotteries</td>
<td>90</td>
<td>84</td>
<td>139</td>
<td>138</td>
<td>157</td>
<td>14.9</td>
</tr>
<tr>
<td>50/7D</td>
<td>Interest on bonds</td>
<td>90</td>
<td>84</td>
<td>139</td>
<td>138</td>
<td>157</td>
<td>14.9</td>
</tr>
<tr>
<td>50/7E</td>
<td>Electricity bills</td>
<td>90</td>
<td>84</td>
<td>139</td>
<td>138</td>
<td>157</td>
<td>14.9</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>6,172</td>
<td>7,987</td>
<td>10,071</td>
<td>18,060</td>
<td>24,804</td>
<td>41.6</td>
</tr>
</tbody>
</table>


Altogether, there has been considerable success in reducing evasion by extending the network of withholding and presumptive taxes. Total revenues under Section 50 of the ITO have grown very rapidly during the last two years, with a cumulative increase of almost 150 percent in 1991–92 and 1992–93 (see table 11). This is the major factor responsible for the unprecedented growth in income tax revenue in recent years. The income tax/GDP ratio has improved by almost one percentage point, from less than 2 percent to almost 3 percent. This has led to a corresponding reduction in the budget deficit compared with 1990–91.

Simultaneously, the component of refunds has been largely eliminated from the tax system (see table 12). These were equivalent to over 14 percent of revenues in 1990–91, but were down to about 4 percent by 1992–93. As a result, tax deductions at source currently account for over 70 percent of total income tax revenue.

The extension of presumptive/withholding taxes has not only contributed to a rapid growth in revenues, but has also probably implied greater equity in the tax system. The share of direct taxes has increased dramatically, and there has been more effective taxation of capital income such as interest, dividends, rent, and the like, which accrue largely to upper-income households. In addition, the change in tax regime has meant greater elasticity of income tax revenues, which are now linked to rapidly growing income streams.
such as interest income from bank deposits, interest on government securities (from rapid growth in government borrowing), income from the rendering of professional services, and so forth.

**Political Economy of the Reform**

Analysis of the political economy of reform requires determination of the gainers and losers of the reform. For this purpose, we set up the simple methodological framework below.

For a particular taxpayer, we designate the following:

- \( y \) = income
- \( T_1 \) = true tax liability
- \( T_0 \) = actual tax liability in old system
- \( T_2 \) = actual tax liability following extension of the withholding/presumptive tax regime
- \( B_0 \) = bribe to income tax officer in old system
- \( C_0 \) = compliance cost to taxpayer in old system
- \( C_2 \) = compliance cost to taxpayer in new regime
- \( D_0 \) = collection cost of department in old system
- \( D_2 \) = collection cost of department in new system.

Based on the above, the outcomes (in net income) in the old system (based on filing of return of global income) were as follows:

- **Taxpayer**: \( y - (T_0 + B_0 + C_0) \)
- **Income tax officer**: \( B_0 \)
- **Government**: \( T_0 - D_0 \) \( \quad (1) \)

The compliance cost, \( C_0 \), includes the cost of maintaining accounts as required by the income tax law, filing the return (possibly with the help of an income tax practitioner/lawyer), making visits to the Income Tax Officer, documentation to handle queries, filing of appeal (if dissatisfied with initial assessment), and the like. These costs could be substantial in financial terms or as opportunity costs of time. Similarly, \( B_0 \) not only includes the value of monetary payment of bribes, but also the monetary equivalent of the psychic cost of engaging in an illegal transaction. \( D_0 \) is the cost of time devoted by the Income Tax Officer and other departmental staff to assessing the return and handling the appeal (if filed).

From (1), it may be observed that there is stable equilibrium (the taxpayer is better-off) if:

\[ T_0 + B_0 < T_1 \] \( \quad (2) \)

and the bribe is less than the difference between the true and actual tax liabilities.

<table>
<thead>
<tr>
<th>Table 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total income tax revenue (Rs million)</td>
</tr>
<tr>
<td>Income tax revenue (% GDP)</td>
</tr>
<tr>
<td>Share (percent)</td>
</tr>
<tr>
<td>Collection of demand</td>
</tr>
<tr>
<td>Payment with returns</td>
</tr>
<tr>
<td>Deductions at source</td>
</tr>
<tr>
<td>Miscellaneous</td>
</tr>
<tr>
<td>Less refunds</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

*Source: CBR Yearbook, 1991–92; Directorate of Research and Statistics, CBR.*
Following introduction of the withholding/presumptive tax regime, we now have these outcomes:

Taxpayer: \( y - (T_2 + C_2) \)
Income tax officer: \( 0 \)
Government: \( T_2 - D_2 \)

We then have the following possibilities:

Case I: \( T_2 > T_0 \)
In this case, despite an increase in actual tax liability, the taxpayer could still be better-off if:

\[ T_0 + B_0 + C_0 > T_2 + C_2. \]

That is,

\[ \frac{B_0}{\text{bribe}} + \frac{(C_0 - C_2)}{\text{saving in compliance cost}} > \frac{T_2 - T_0}{\text{additional tax payment}}. \]  

Therefore, the taxpayer is better-off (and a gainer) if the increase in tax liability is less than the bribe in the old system plus the saving in compliance costs brought about by the introduction of the new system. Taxpayers who are more effectively taxed under the new system, however, are likely to be worse-off.

The government is a gainer if

\[ T_2 - D_2 > T_0 - D_0. \]  

This is likely to be the case if \( T_2 > T_0 \), because collection cost, \( D_2 \), in the new system is lower than \( D_0 \).

Because no bribe is paid in the new system, the Income Tax Officer is worse-off (and a loser). Therefore, in this case both the taxpayer and government are potential gainers, while the income tax officer is a loser. If, however, the taxpayer had succeeded in avoiding declaration of his income by not filing a return, he will be worse-off in the new system. This takes us to the next case.

Case II: \( T_2 < T_0 \)
In this case, condition (3) is always satisfied, and the taxpayer is unambiguously better-off. The government is a gainer or a loser depending on whether condition (4) is satisfied or not. The former outcome is the case if the savings in costs of collection exceed the loss of revenue. Therefore, in this case, while the taxpayer is clearly better-off (a gainer), and the Income Tax Officer worse-off, the government can be either a gainer or a loser.

Combining the two cases, we have the conclusion that relatively honest taxpayers who declared a higher proportion of their income in the old system are likely to be gainers, while tax evaders lose. The government generally is also a gainer, unless the withholding/presumptive tax rate is pitched at very low levels. The clear loser from the reform is the income tax officer, who no longer has the power to extract bribes. It is interesting to note that agents of the state tax collection machinery have a strong vested interest in blocking this reform, and are therefore unlikely to adopt a neutral or promotional stance.

**Determinants of Success**

**Role of Gainers**

In its vision of change, the Nawaz Sharif government, which was sympathetic to business interests, forcefully articulated the view that the income tax system had failed. On the one hand, it did not generate enough revenue because of rampant evasion and corruption. On the other hand, it had become a hindrance to the smooth conduct of private sector economic activities because of the high taxpayer compliance costs, the frustration resulting from harassment by tax officials, and the arbitrary nature of assessments that led to lengthy and time-consuming appeals processes. In his public statements, the prime minister said that evaded income was as much as five times the declared income, and that while this was the result of fundamental problems of taxpayer compliance and morality, it was also the consequence of thoroughly inefficient and corrupt tax machinery. Newspapers frequently carried information about sackings and transfers in the income tax department.
The RMTRC was charged with the responsibility of proposing and implementing reforms in the tax system. In its initial meetings with Chambers of Commerce and Industry and various trade associations, there was unanimous affirmation of the need to simplify the income tax system by the introduction of presumptive/withholding taxes to reduce the discretion of tax officials and lessen harassment and compliance costs. It was also commonly asserted that simplification of the tax system could actually generate more tax revenues by curbing tax evasion. The common argument put forward by businessmen was that rather than pay bribes, which went into the pockets of corrupt tax officials, they would much prefer that these payments be converted into revenues for the government.

Lobbying activities to bring about the desired changes in the tax system were intense. The Nawaz Sharif government made a significant departure from past practice by substantially “opening up” the budget-making process to outside interests. Traditionally, this task had been performed by the bureaucracy in a climate of almost complete secrecy. A high-powered Budget Committee was convened (chaired by the prime minister), with representation of leaders of trade and industry. These representatives forcefully argued in favor of mechanisms for reducing tax evasion, because it compelled them to pay higher tax rates to achieve the targeted level of revenues. They also presented proposals for tax simplification through introduction of presumptive/withholding taxes on different streams of income and in different sectors of the economy.

Role of Agents of the State
This area of reform is unique, because one component of the state, the tax collection machinery, actually had a vested interest in the nonimplementation of this reform. Presumptive/withholding taxes reduce the role of the income tax department and lead to a decentralization of tax collection. At the individual level, tax officials find their income levels drastically reduced because there are fewer bribes.

The CBR as a whole, however, and the income tax department in particular, had already been subjected to a great deal of criticism because of historically poor performance in tax collection, as reflected in the low and stagnant tax/GDP ratio. Therefore, revenue officials found themselves in a position where they could not forcefully argue against the violation of the traditional norms of income taxation based on filing returns of global income by taxpayers. The aggressive attitude of the prime minister and the danger of punitive action through large-scale removal and sacking of tax officials represented a credible threat to their position. The tax bureaucracy decided that the best policy was to go along with the reforms, at least temporarily, and see how presumptive/withholding taxes performed. Also, the tax department was effectively bypassed when responsibility for development and implementation (through provisions in the Finance Acts) of proposals was given to the RMTRC, and actual responsibility for collection shifted to large public sector and corporate entities.

Another factor contributing to success was that other organs of state, primarily senior officials of the ministries of finance, industry, and commerce, fully supported the move. Not only was there a desire to increase the flow of revenues into the exchequer by curbing evasion, but there was also general sympathy with the view that the existing tax system had failed because of the complexity of laws and the inefficiency and misconduct of tax officials. In more cynical terms, it seems that other elements of the bureaucracy felt that there was a disproportionate allocation of lucrative positions to the tax department, and this imbalance required remedy.

Role of Losers
Losers from the reform belong to two distinct groups, income tax officials and tax evaders (who either did not file any return or underdeclared a
substantial proportion of their income, and subsequently escaped assessment). As indicated above, the former could not lobby aggressively against the reform because of the prevailing climate of hostility toward their role, and the prospect that if revenues did not improve quickly, there could be large-scale retrenchment of the income tax department. Within this group, the few honest officers were inclined to support this reform, because it considerably simplified their jobs and reduced their assessment load.

Chronic tax evaders did not fall into a homogenous category. By definition, it was difficult for them to reveal their identity lest they become targets for any future revenue drive. Also, there was a realization that the government meant business, and the alternative to the reform was potentially worse, because it meant stronger investigation and enforcement activity by the department. The pragmatic approach was to pay somewhat more in the form of presumptive or withholding taxes, while preserving anonymity and not coming into contact with tax officials.

Of course, not all opposition to the reform was muted. Income tax practitioners, lawyers, and accountants found that their practices would be severely eroded by the transition to a simpler tax system. There were also some tax purists who felt that the introduction of presumptive and withholding taxes represented a vulgarization of the system. A campaign was launched in the newspapers, and echoed occasionally in the higher echelons of government, that the shift from global to scheduler income taxation (for example, of interest income) would reduce the progressivity of the tax system; that levy of fixed taxes on crude proxies to income, such as turnover, would convert direct taxes to indirect taxes, leading to a shifting of the tax burden; and that the problem of inequity would be exacerbated because the presumptive withholding tax regime would not be able to distinguish between persons with income below the exemption limit and those with taxable income. Consequently, the argument continued, the system would end up taxing poor households, widows, orphans, and the like. Nevertheless, all these arguments paled in the face of a government that appeared to be determined to simplify the tax system, reduce arbitrariness and harassment by tax officials, broaden the base of income tax by checking evasion, and generate more tax revenues.

**Lessons Learned**

The extraordinary success achieved in implementation leads to the identification of the main elements of governance capacity that contribute to successful adjustment. In the context of the above case study, these include the following.

- A government that was able to adequately articulate the need for the reforms as part of its overall vision of social and economic change, and successfully portray the losers in the reform (tax evaders and income tax officials) to the general public as the “devils” of the system, who had exploited the laws and led to a breakdown of the tax machinery, implying a slackening of the overall fiscal effort.
- An approach to reform that was shown to be superior to other approaches in the costs imposed on society at large and the time frame for achieving gains. Mechanisms for tackling evasion were shown to be better than a policy of raising tax rates (to generate more resources from existing taxpayers) or stronger enforcement activity (leading to more harassment and corruption).
- Ability to build a strong base of diversified support for the reform from business, employee, and other interest groups.
- Strong leadership from the chief executive, the prime minister, who personally campaigned for the reform and presented proposals for its implementation.
- Adoption of an approach that essentially bypassed one major loser, the income tax department, by decentralizing the process of tax collection.
• Presence of credible threats to losers, that if the reform was not implemented, they would actually be even worse-off. For the income tax department, this meant large-scale retrenchment; for tax evaders, the prospect of stronger enforcement activity and detailed investigations. In a perverse way, therefore, potential losers stood to gain from the reform, which preempted even stronger action.

• Opening of the budget-making process, leading to greater transparency and access to new, innovative approaches.

• Lack of homogeneity and difficulty in coordination within one major group of losers, the tax evaders. Transaction costs of building an organization and a common front were too high. Lobbying against reform had to be done by surrogates such as tax practitioners, lawyers, and accountants, whose level of commitment was not very great.

• The reform package gained momentum over time, because it was able to demonstrate very quickly a considerable degree of success, as measured by the phenomenal growth in revenues.

Altogether, this reform experience was unique in the Pakistan setting, because most of the positive aspects of governance capacity came together in ensuring its success.

Base-Broadening and Rate Reductions in Direct Taxes

One of the major elements of the strategy of tax reform is to broaden the base of taxes, especially direct taxes, and simultaneously bring down tax rates. This will not only protect (and perhaps even increase) revenues by reducing the incentive for evasion, but will also lead to a more neutral and efficient tax structure with less distortionary effects on the economy. In this section, the success Pakistan has had in achieving this component of tax reform will be considered. Broadening the base through withdrawal of major exemptions is an excellent case study, highlighting the political economy of the tax reform process.

Degree of Success in Implementation

As we described earlier, the income tax system of Pakistan is characterized by a large number of exemptions, tax credits, rebates, concessions, and the like, which have led to substantial revenue losses. The estimated magnitude of tax expenditures (revenue cost of the differential tax treatment) is colossal, and in excess of revenues actually collected, as shown in table 13.

Major tax expenditures include statutory exemption of major public corporations (such as WAPDA and T&T), interest income from government savings instruments, agricultural income and wealth, capital gains on financial assets, tax holidays, salary perquisites in cash and in kind, export income, accelerated depreciation allowances, owner-occupied properties, and so forth. The total revenues foregone because of these exemptions and concessions is over 2 percent of GDP. This is one major reason that the direct tax/GDP ratio was very low, less than 2 percent of GDP in 1990–91, compared with over 7 percent for other developing countries at a comparable stage of development.

Given these large-scale concessions, the government needed to pitch tax rates at relatively high levels. During most of the 1980s, the maximum marginal tax rate for personal income tax was as high as 60 percent. The corporate tax rate was 55 percent. These high tax rates had placed a premium on tax evasion.

The tax reforms pursued in Pakistan appear to have been launched with an upfront announce-
Governance and Fiscal Reform: A Study of Pakistan

Table 13
Estimates of Tax Expenditure in Direct Taxes in Pakistan, 1990–91
Rs million

<table>
<thead>
<tr>
<th>Type of exemption / concession</th>
<th>Tax expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax holidays</td>
<td>350*</td>
</tr>
<tr>
<td>Capital gains on financial assets</td>
<td>1,100*</td>
</tr>
<tr>
<td>Bonus shares</td>
<td>170*</td>
</tr>
<tr>
<td>Salary perquisites</td>
<td>2,800*</td>
</tr>
<tr>
<td>Interest income from government savings instruments</td>
<td>3,100*</td>
</tr>
<tr>
<td>Income of public corporations</td>
<td>5,600*</td>
</tr>
<tr>
<td>Agricultural income</td>
<td>3,000*</td>
</tr>
<tr>
<td>Agricultural wealth</td>
<td>3,300*</td>
</tr>
<tr>
<td>Rebate on export income</td>
<td>1,800*</td>
</tr>
<tr>
<td>Accelerated depreciation allowances</td>
<td>1,200*</td>
</tr>
<tr>
<td>Exemption of owner-occupied properties from wealth tax</td>
<td>700*</td>
</tr>
</tbody>
</table>

Total tax expenditure 23,120
Total direct tax collection 19,868
Tax expenditure as percentage of revenue 116

a. Economic approach.
b. Accounting approach.
Source: Ahmed and others 1993.

ment of tax rates, without any link to a simultaneous removal of exemptions. In this sense, the approach of bargaining with particular social groups was not adopted. This has made it politically more difficult to subsequently withdraw concessions.

In the Finance Act of 1991, the government announced an immediate slashing of personal income tax rates, with the maximum marginal tax rate cut to 35 percent. For the corporate sector, it was proposed to bring down rates substantially over a five-year period starting in fiscal year 1992–93. The decline envisaged by 1997–98 is from 66 percent to 55 percent in the case of banking companies, from 44 percent to 30 percent for public companies (other than banking companies), and from 55 percent to 40 percent for other companies. In addition, the supertax, or surcharge, on companies was withdrawn. It is likely that this measure contributed greatly to reduction in uncertainty about future tax rates and facilitated better investment planning.

Up to the budget for fiscal 1994–95, however, no major success appears to have been achieved in the rationalization of the major exemptions and concessions in direct taxes mentioned above.² The last caretaker government (from July to October 1993) made a bold attempt at introducing both income and wealth taxation in the agricultural sector through ordinances. These were proposed as schedular, presumptive (linked to produce index units of land) taxes to simplify the process of administration. Tax rates were deliberately kept low to minimize resistance. The present government, however, with strong support from the feudal lobby and a rural vote bank seen in the 1993 elections, has allowed the agricultural income tax ordinance to lapse (except for one province, the NWFP), while the wealth tax proposal was accepted and embodied into law. In the latest Finance Act the special exemption to wealth in the form of agricultural land has been increased tenfold, from Rs 100,000 to Rs 1,000,000. This implies that although agricultural land is part of the wealth tax net, very few landowners will actually end up paying this tax. Also, agriculturists have generally refused to file wealth tax returns.

This failure in withdrawal of the major exemptions and broad-basing of taxes clearly demonstrates the lack of political will in government to take on the powerful social groups that enjoy special privileges in Pakistan. The historic opportunity to strike a bargain with these groups at the time tax rates were brought down appears to have been lost. The failure of this reform implied that

² Some minor exemptions embodied in the second schedule of the Income Tax Ordinance have, of course, been withdrawn. This includes the tax credit on balancing, modernization, and replacement of machinery; income of Chambers of Commerce and Industry and stock exchanges; moderabas (after the first three years); some welfare trusts; and financial institutions.
potential revenue gains of between 1 and 2 percent of GDP have not been realized. This could have made a major contribution to reducing the budget deficit.

**Political Economy of the Reform**

Determination of gainers and losers in reform that involves broad-basing the income and wealth tax, coupled with a reduction of tax rates, requires development of a simple methodological framework.

We designated the following:

- $y$ = global income of a taxpayer
- $y_T$ = taxable income (existing provisions)
- $y_N$ = exempt income (existing provisions)
- $t_0$ = existing tax rate (assumed for simplification purposes to be proportional, as in the case of corporate income)
- $t_1$ = new tax rate.

The existing tax liability, $T_0$, can be derived as

$$T_0 = t_0 y_T.$$  \hspace{1cm} (1)

In the event that all exemptions are withdrawn, the new tax liability, $T_1$, is given by:

$$T_1 = t_1 y.$$  \hspace{1cm} (2)

Therefore, the taxpayer is a loser if:

$$T_1 > T_0$$

that is,

$$t_0 y_T < t_1 y$$

and

$$\frac{t_1}{t_0} > \frac{y_T}{y}$$

or

$$\frac{t_1}{t_0} > 1 - \frac{y_N}{y}$$

which transforms to

$$\frac{y_N}{y} > \frac{t_0 - t_1}{t_0}.$$  \hspace{1cm} (3)

This implies that for the taxpayer, if the percentage of his income that was originally exempt exceeds the percentage decrease in the tax rate, then he is worse-off.

Therefore, taxpayers can be separated into losers and gainers from a reform package involving broad-basing of direct taxes and reduction of tax rates. The status of taxpayers under the reform depends primarily on the extent to which their income is in exempt forms. A similar result can be obtained in the case of the wealth tax.

This, however, essentially assumes that there is a simultaneous reduction in tax rates and withdrawal of exemptions. If a two-step procedure is followed, as happened in Pakistan, then the results could be very different. If, in the first step, only tax rates are lowered, then all taxpayers benefit and there is unambiguous support for this reform. If a subsequent attempt is made to withdraw exemptions, all taxpayers with exempt income potentially lose (in relation to their position after the first step), and there is every likelihood that this phase of the reform will be strongly resisted. Therefore, the optimal strategy, which maximizes chances of success, is a simultaneous movement on both broad-basing taxes and reducing tax rates.

**Determinants of Success**

**Role of Gainers**

The real gainers from reform are the general population of relatively poor households, who can expect that a rise in direct tax collections will lead to some alleviation of the burden of indirect taxes, which fall primarily on them, or that the overall increase in tax revenues will lead to some reduction in the budget deficit and less inflationary financing, which burdens them with a disguised tax.

Given the complexity of the income tax code and the generally low level of literacy in Pakistan, however, there are serious information problems with regard to gainers. Very few people have knowledge of the wide array of exemptions and concessions embodied in the direct tax system. It is only recently that research by independent institutions has demonstrated the sizable tax breaks that exist, especially for the rich, in Pakistan. But an awareness campaign remains to be launched.
The government has been reluctant to disseminate this information, lest it sharpen the class struggle and lead to a further decline in voluntary taxpayer compliance.

Knowledge of the favored treatment granted to agricultural income, however, is widespread. This has been a flash point of debate over the last forty-seven years, since the creation of Pakistan. It has now become a symbol of the conflict between the new emerging urban middle-class and the traditional rural feudal elite. By now the degree of polarization on this issue is complete.

Other gainers are social groups who traditionally have received most of their income in taxable forms. This includes salaried taxpayers, who have benefited significantly from the large decline in personal income tax rates. Nevertheless, this group is apprehensive that any change in the tax treatment of salary perquisites in cash or in kind will once again raise tax liabilities. The corporate sector has also gained, although in the short run the tax savings are not so sizable. Resistance, however, is likely to efforts to broaden the tax base by withdrawal of tax holidays, accelerated depreciation allowances, exemption on bonus shares, and the like.

*Role of Agents of the State*

The attitude of agents of the state toward the reforms has been ambivalent. On the one hand, there is a commitment to a more neutral, less distorting tax regime. On the other hand, there is concern that if specially targeted concessions are withdrawn, there could be adverse economic consequences, and the government could be accused of being anti-agriculture, anti-export, anti-savings, anti-investment, anti-backward-areas, and so on. Consequently, the same degree of commitment was not visible on the part of the Nawaz Sharif government to this part of the tax reforms as to extension of presumptive and withholding taxes.

For example, in the context of withdrawal of the exemption of agricultural income, the IJI government was particularly vulnerable to the criticism that it was anti-agriculture, because it had strong support from business and trade interests in the cities. The government had to consider that the feudal class still had considerable political clout, and would play a vital role in future elections. It is ironic that although the Nawaz Sharif government did not promulgate the agricultural income tax, it still lost in the rural areas of Pakistan in the 1993 elections.

Tactically, it appears that the government played its cards badly in the reform process. The opportunity to engage in bargaining with different social groups for a tradeoff between withdrawal of exemptions and reduction in tax rates was not utilized. There was too much of a hurry to appease the vote bank of business interests by announcing a reduction in corporate and personal income tax rates. Also, the Nawaz Sharif government was convinced that purely from the viewpoint of increasing private investment in the economy, it was necessary to bring about a reduction in tax rates. This conviction was perhaps motivated by a more dynamic understanding of the relationship between the growth of tax bases and tax rates (or supply-side economics).

*Role of Losers*

Behind each major tax exemption or concession in Pakistan, there is a strong, entrenched, vested interest group. Each group has organized itself as an effective lobbying entity, which has not only blatantly demonstrated its power in political terms, but also has, in a more subtle fashion, played the game of seeking patronage through party donations, buying off influential politicians, and so forth, and has developed credible arguments to explain why retention of these exemptions and fiscal incentives is actually in the greater national interest.

Perhaps the best example of this is the agricultural lobby. It is extremely well-organized and enjoys enormous political power. A large majority of the elected members of the Parliament either represent the feudal class or are sympathetic
Figure 2
Arguments against Withdrawal of Major Exemptions and Concessions in Direct Taxes

<table>
<thead>
<tr>
<th>Type of exemption/concession</th>
<th>Arguments given in favor of retention of tax benefit</th>
</tr>
</thead>
</table>
| Tax holidays                 | • Adverse impact on the overall level of private investment in the economy.  
                                • Difficult to divert entrepreneurs to backward areas, and thereby reduce regional disparities, in the absence of the fiscal incentives.  
                                • Need for tax breaks to induce private investment in high-risk, high-tech industries.  
                                • Support to infant industries.  
                                • Necessary for attracting foreign private investment.  
                                • Higher investment (resulting in increased production) yields higher indirect tax revenues (excise duty and sales tax), which more than justify the tax expenditure. |
| Exemption of interest income on government savings instruments | • Raise the level of household savings in the economy.  
                                • Divert funds to government and reduce need for resort to inflationary mechanisms to finance the budget deficit.  
                                • Improve income distribution, because investment mostly by lower- and middle-income households.  
                                • Withdrawal of exemption confers no benefits to the exchequer because increased revenues will be used largely to increase pretax rates of return to keep post-tax rates of return constant.  
                                • Need for favored tax treatment to induce investment in long-term assets. |
| Capital gains on financial assets | • Promote development of the capital market for channeling savings, especially through stock exchange.  
                                • Tax deductibility of interest payments has created preference for debt financing. Therefore, exemption of capital gains on financial assets is necessary to preserve incentive for equity financing.  
                                • The share price index is a barometer of the economy. If tax benefit is withdrawn, share prices will plummet.  
                                • Necessary to attract foreign portfolio investment in the stock market, which helps improve the balance of payments position.  
                                • Taxation of capital gains is difficult because scope for evasion in reporting of such income is high.  
                                • Capital gains must enjoy different tax treatment in any case, because it may largely represent inflation-linked, and not real, increases in value. |
| Salary perquisites, cash or in kind | • Employee remuneration package is relatively low in Pakistan, and tax break on perquisites is necessary to preserve reasonable standard of living.  
                                • If multinationals are to be attracted into Pakistan with high-level technical and administrative manpower, such tax breaks are necessary.  
                                • Provision of salary perquisites in kind automatically indexes a part of the remuneration package to inflation.  
                                • If benefits in kind are monetized into a cash salary, tax burden will rise disproportionately, and reduce incentives for greater effort. |
| Income of public corporation | • These corporations provide basic services such as power, telecommunications, and the like. Growth in demand implies rapid growth in financing requirements, part of which can be met at relatively low cost through savings in tax payments.  
                                • The tax benefit keeps down prices of utilities and encourages growth in the economy.  
                                • The tax benefit reduces borrowing requirements of large public corporations, which effectively means lower budget deficit and interest rates. |
| Agricultural income/wealth | • Agricultural income is already subject to heavy disguised taxation in the form of procurement and support prices that are significantly below world prices. |
Figure 2—continued

- Taxation of agricultural income will reduce food production, which is vital for national security.
- Taxation of agricultural income will impose high costs of collection, which will not be justified by the low likely revenue yield.

<table>
<thead>
<tr>
<th>Rebate on export income</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Vital to boost exports to improve foreign exchange position. Fiscal incentive is necessary, especially to achieve diversification of export products and markets.</td>
</tr>
<tr>
<td>• There is strong anti-export bias because of the overvalued exchange rate and high protection against imports. Need to remove this bias at least partially through rebate.</td>
</tr>
<tr>
<td>• Exports are supply-elastic and will decline precipitously if the income tax rebate is withdrawn.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Accelerated depreciation allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Need to raise post-tax rates of return, especially in initial years, to promote private sector investment in industry.</td>
</tr>
<tr>
<td>• Need to encourage provision for depreciation to finance subsequent replacement investment.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Owner-occupied properties (from wealth tax)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Need to encourage home ownership as a means of security and comfort.</td>
</tr>
<tr>
<td>• Since there is no cash income from owner-occupied property, there will be serious liquidity problems in payment of taxes.</td>
</tr>
<tr>
<td>• Owner-occupied property is already subject to the provincial property tax. Removal of exemption will lead to double-taxation.</td>
</tr>
<tr>
<td>• Widows, orphans, and others without large incomes will be adversely affected. In this sense, it will represent an oppressive form of taxation.</td>
</tr>
</tbody>
</table>

Source: Public statements as witnessed by author, newspapers.

to the interests of this group. It is not surprising, therefore, that any legislation to change the status quo is effectively blocked. A number of arguments have been developed to justify the tax exemption of agricultural income (see figure 2), including the contention that the sector is already overtaxed through the pricing mechanism (domestic prices below world prices), that food production is vital for national security, and that the high costs of collection of the tax on agricultural income will not be justified because of the low likely revenue yield.

Tax holidays have been aggressively supported by industrial interests, which have formed an alliance with the provincial governments of backward areas. They have been successful in playing up the sensitive issue of the large and widening regional disparities in the country. The Ministry of Finance (a key agent of the state itself) has justified the exemption of interest income on government savings instruments on the grounds that this actually improves the income distribution because the bulk of the participants in such savings schemes are from lower- and middle-income households, and that this incentive reduces the need to resort to inflationary mechanisms to finance the budget deficit.

The need for retention of the capital gains on financial assets has been successfully argued by representatives of the stock exchanges in the country. The various associations of members of the stock exchanges have portrayed the share market as a barometer of the performance of government and the economy. They have stressed the need for fiscal incentives to attract foreign private portfolio investment, and thereby improve the balance of payments position, and so on.

Altogether, tax reform involving broad-basing of direct taxes by removal of major exemptions and concessions has been effectively frustrated by entrenched, powerful, well-organized, and articulate interest groups. The government has
had to retreat in the face of opposition from such
groups. It has been left with the worst possible
outcome. Tax rates have come down, while the
plethora of tax expenditures continue.

Lessons Learned

The virtual total failure of government to broaden
the base of direct taxes by withdrawal of exemp-
tions or concessions leads to the identification
of a number of factors that mitigate against the
success of reform initiatives. These include the
following.

- Ambivalence and a resulting lack of commit-
ment to the reform by agents of the state, aris-
ing from a perception that the reform may
damage vital national interests such as food
production, savings, exports, and the like.
- "State capture" by special interest groups such
as the traditional feudal elite, bureaucracy,
defense establishment, and the emerging cor-
porate business interests, which extract sub-
stantial rent from the existing tax expenditure
system, and are unwilling to give up their
privileges.
- Bad implementation of reforms. By first
reducing tax rates, the opportunity for bar-
gaining with (and compensating) losers was
lost.
- Strong coordination among potential losers.
Each group of losers had established repre-
sentative and articulate bodies that could
present their case and lobby intensively in the
inner-sanctums of government, in Parliament,
and in the popular press.
- Dispersed gainers, consisting largely of rela-
tively poor households with no taxable in-
come, or households with taxable forms of
income. There were serious information prob-
lems because of a general lack of knowledge
of tax expenditures, which largely remain hid-
den from the public eye.
- Successful campaign launched by poten-
tial losers that the status quo (that is, reten-
tion of tax incentives and concessions) is
better. Potential gainers were convinced
through well-presented arguments that they
might be even worse-off if reforms were
implemented.

This case study thus demonstrates how in the
presence of negative elements of governance ca-
pacity, objectively desirable reforms can be largely
frustrated.

Ongoing Reforms

The present elected government of the PPP
under Benazir Bhutto inherited an econ-
omy beset with the continuing prob-
lems of a large budget deficit, a decline in the
growth rate of the economy (from 6 percent to
about 4 percent), and a perilously low level of
foreign exchange reserves. In late 1993, soon
after its installation, the government signed
an agreement with the International Monetary
Fund for the Extended Structural Adjustment
Facility (of SDR 606.6 million) and the Ex-
tended Fund Facility (of SDR 379 million).

The agreement involves wide-ranging reforms,
to be implemented between 1994–95 and 1996–
97, in diverse areas that include taxes and pub-
lic expenditure, administered prices, intergov-
ernmental fiscal relations, trade, the finan-
cial sector, privatization, deregulation, and
agricultural pricing. One of the major macro-
conomic targets in the agreement is a
reduction in the budget deficit to about 3 percent
of GDP by 1996–97. The path of fiscal ad-
justment from 1994–95 onward is predicated
on structural reforms in taxation and public
sector pricing and sustained efforts to reduce unproductive expenditure.

Within the area of tax reforms, the agreement focuses on several areas: first, reduction of wide-ranging exemptions and concessions in direct taxes (of the kind discussed in the previous section); second, development of the general sales tax (GST) as a modern, broad-based VAT (along with adjustments in excise taxes), and its extension to trade and services; and third, rationalization of trade taxes, primarily through tariff reforms that involve merger of para-tariffs, scaling down of the maximum tariff rate, and withdrawal of exemptions.

**Broad-Basing of the General Sales Tax**

The primary motivations for broad-basing the GST, following its conversion in 1990–91 to a VAT-style tax with tax invoicing features, are: first, to compensate for revenue losses from the ongoing tariff reforms (discussed in the next section); second, to move the tax base toward consumption to encourage savings; third, to achieve a more neutral tax structure by taxation of a broad range of items (excluding food and other necessities); and fourth, to bring about the process of greater documentation of the economy as a result of the incentives created for invoicing to claim tax refunds.

**Progress in Implementation**

The GST was levied on 59 additional industries between 1991 and 1993. Many of these industries are small in value, however, and revenue gains have been marginal. In an attempt to cover small units, a noninvoicable GST at the rate of 5 percent has also been introduced. Simultaneously, in some industries a kind of forfeit system has been introduced, leading to the negotiated fixed tax liabilities of all units within an industry. Some tentative attempts have been made to extend the GST to the wholesale and retail trade sector, and thus give it more of the character of a consumption tax. The Nawaz Sharif government was reluctant to fundamentally extend the tax net to this sector because of a virtual absence of documentation of transactions, and because the urban trading community represented a major support base for the IJI government. In the budget of 1993–94, primarily out of considerations of revenue enhancement, the standard GST rate was raised from 12.5 percent to 15 percent.

The Finance Act of 1994 represents a major effort to broad-base the GST. An additional 277 industries, excluding those producing food items, have been brought into the tax net. Simultaneously, the fixed sales tax system has been abandoned on the grounds of inelasticity of revenues and low effective rates. This reform, however, led to a nationwide strike by business and trading interests that compelled the government to temporarily suspend the withdrawal of the fixed tax system and evaluate industries proposed for inclusion in the GST regime.

**Gainers and Losers**

The potential gainers from reforms of the sales tax are the recipients of benefits financed by the additional revenues, or from the decline in inflation resulting from less deficit financing. Of particular significance in this context is that 80 percent of the revenues from GST accrue to the provinces, and are likely to be used largely for enhanced provision of social and economic services such as education, health, roads, and water supply. Also, large-scale units that have been placed at a competitive disadvantage are likely to support the collection of the tax from smaller units.

Losers are essentially industries that are brought into the tax net as a result of the broad-basing measure. Depending on the relevant price elasticities, however, at least part of the burden of the tax is shifted forward to consumers, who in this sense are the real losers. Opponents of the reform have argued that this will put a regressive tax burden on households. Given that the burden of the tax can be shifted, it is perhaps surprising that there is so much resistance from industry to
the imposition of this tax. The reasons for this re-
tolerance are: first, greater documentation of trans-
actions increases the ability of the tax department
to more efficiently ascertain income tax liabili-
ties; second, even though the system is based on
self-assessment rather than supervised clearance
of consignments (as in the case of excise duties),
there is the prospect of payment of bribes to tax
officials at the time of registration and the annual
audit; and third, the VAT nature of the tax imposes
substantially higher compliance costs on tax-pay-
ers because of the need to maintain proper records
and accounts. These factors are responsible for
the strong preference of industry for the fixed sales
tax system. Also, it appears that special factors
have been operative in 1994. Given the conditions
of an economic recession, the view of business is
that enhancements in indirect taxes at this time
can only add to the problem of stagnant or declin-
ing output levels. Furthermore, given the impend-
ing tariff reforms, industry believes that imposi-
tion of the GST will further impair competi-
tiveness with respect to imported goods.

Determinants of Success

The support for mobilizing revenues from the GST
has been greatly diminished by the indirect na-
ture of this tax and its tendency to raise prices.
There is widespread opposition in Pakistan to fur-
ter enhancements in indirect taxes, which already
account for the dominant share of revenues. These
taxes are generally considered as regressive,
distortionary, and inflationary in character. It is
unlikely, therefore, that there will be major spon-
taneous support for the broad-basing of the sales
tax, even if it is shown that it can fetch substantial
additional revenues. From the viewpoint of both
equity and efficiency, the popular demand is for
resource mobilization through reduction in eva-
sion and elimination of concessions in the direct
tax system.

There is apparently a degree of contradiction
in tax policy that highlights problems of commit-
tment on the part of the agents of state. In the con-
text of direct tax reform, the philosophy has es-
sentially been one of simplification, reduction in
compliance costs, and less direct contact with tax
officials. This explains the move toward presumpt-
tive and withholding taxes (discussed in the fourth
section). In the area of indirect taxes, however,
the emphasis now is on the introduction of a broad-
based VAT, a sophisticated tax that has found its
place internationally only in the last two decades.
It will require high levels of documentation and
force substantially higher compliance costs on tax-
payers. This contradiction has sent confusing sig-
als about the broad directions of tax reform in
the country. Many of the senior tax officials are
not entirely clear about the mechanisms of opera-
tion and economic benefits of a VAT. The lack of
commitment to a pure form of VAT is evidenced
by the eagerness with which improvisations in the
form of presumptive, fixed, or noninvoicable
GSTs have been adopted in special cases in the
past. Perhaps in recognition of the perceived lack
of commitment to reforms in the GST, the prime
minister, in her speech on the eve of the presenta-
tion of the budget for 1994–95, extolled the virtu-
es of a sales tax.

It also appears that the pace of implementa-
tion of the reform has been artificially increased
by the presence of IMF conditionalities. Conse-
quently, the broad-basing is taking place without
adequate strengthening of the tax department,
proper survey, registration and education of tax-
payers, and printing and circulation of forms. This
will jeopardize the successful implementation of
the reform proposals.

The strong resistance to extension of the GST
has motivated government to take some poten-
tially significant actions. The most important tac-
tical move is to bifurcate the present chambers
into separate bodies for trade and industry, respec-
tively, on the grounds that interests fundamentally
differ. Traditionally, industry has had the neces-
sary lobbying powers in the corridors of Islamabad
(as demonstrated by the effectiveness of the All
Pakistan Textile Manufacturers Association,
APTMA), while trade has provided the street muscle at times of agitation. The break-up of this coalition could potentially weaken opposition to reforms such as a scaling down of tariffs or broad-basing of the GST. It is also possible that in subsequent attempts at reform, government may try to split existing taxpayers away from new entrants into the tax net by simultaneously announcing a reduction in the tax rate (say, back to 12.5 percent) and a major broad-basing initiative, such as extension of the GST to the retail level.

The effectiveness of losers in organizing a coalition to resist the reform has already been demonstrated. The success achieved will strengthen the motivation to block future changes. A crucial time will arrive next year, when a fundamental step is proposed by government (as part of the agreement with IMF)—to extend the GST to the wholesale and retail trade.

The experience with reforms of the GST demonstrate how an effective coalition of potential losers can be organized in the presence of weak support for the reform from potential gainers that results from the dispersed, uncertain nature and uneven distribution of gains, and agents of state who have demonstrated some lack of consistency, commitment, and preparedness for the reform.

Tariff Reforms

As highlighted earlier, Pakistan’s taxation system is characterized by excessive dependence on taxes on international trade. Statutory tariffs are high, and while these were justified in the past on the basis of the “infant industry” argument, their continuation has perpetuated excessively high levels of protection to a large number of industries, including those that are inefficient (either with negative value added at world prices or high domestic resource costs). This has led to a large-scale diversion of resources toward import substitution and created a strong anti-export bias. High tariffs have also encouraged rampant smuggling (of over 5 percent of GDP according to PIDE 1993), which has not only eroded the tax base and adversely affected industrial production, but has also implied all the social evils associated with the generation and use of illicit incomes.

Technical flaws have also crept into the tariff structure. Ad hoc tinkering with rates, largely for revenue purposes, has created fiscal anomalies. There is no rational “cascading” of rates, and average rates do not vary significantly by stage of processing. High statutory tariffs have led in many cases to the promulgation of SROs to grant exemptions or concessions by region, type of end use, or nature of importer. This has greatly complicated customs administration and promoted corruption and rent-seeking activity. In 1992–93, almost half of dutiable imports paid concessionary duties under the provisions of some SRO. Therefore, tariff reforms are required, not only from the viewpoint of influencing the future process of industrialization of the country in the desired directions, but also for rationalizing the tax regime, making it simpler to administer and transparent, while using fiscal policy as the prime instrument for tackling the problem of smuggling.

Progress in Implementation

A gradual process of reforms in the trade regime has been ongoing in Pakistan for some time. In the first phase, quantitative restrictions on imports were largely removed, and the “negative” list now largely consists of items that are prohibited for religious or other reasons. During the last few years, the maximum tariff rate (except for automobiles) has been brought down from 225 percent to 80 percent. Efforts at reform have been piecemeal in character, however, and no attempt has been made to bring about comprehensive changes that eliminate fiscal anomalies and provide well-defined signals for allocation of domestic resources.

The last caretaker government formed a Tariff Reforms Committee to develop a new tariff structure to be implemented over a three-year period, keeping in view the impact of the proposed
changes on levels of effective protection to industry, overall tax revenues, and the trade balance. The committee had interministerial representation, and also sought the view of leaders of major industries.

The committee made a large number of recommendations, including: first, the abolition of para-tariffs; second, scaling down of the effective (inclusive of surcharges and license fee) maximum tariff from 92 percent to 50 percent over the three-year period; third, cascading of tariffs, with lowest rates for noncompetitive, primary raw materials, and highest rates for finished goods; fourth, promotion of exports by duty-free imports of raw materials, intermediate goods, and machinery for export-oriented sectors, while simultaneously phasing out the cumbersome and difficult to administer export rebate scheme; fifth, protection to locally fabricated machinery; sixth, duty-free imports of food and other basic items; seventh, sizable tariff reductions on items prone to smuggling; eighth, large-scale withdrawal of SROs, including removal of differential treatment between industrial and commercial importers and concessions to public sector entities; and ninth, introduction of minimum tariffs to reduce rate dispersion.

The committee carried out case studies of effective protection, before and after reforms. Contrary to expectations perhaps, it was able to demonstrate that protection actually increased in over half of the industries studied following reform, despite lower levels of tariffs, primarily because of cascading. Also, preservation of revenue neutrality was proposed, with 50 percent of the revenue losses being recovered by phasing out SROs, 35 percent by broad-basing of the sales tax, and 15 percent by withdrawal of exemptions in the income tax regime. Impact on the level of imports was not considered to be sizable, because the stimulatory effect exercised by lower tariffs was likely to be counterbalanced by the withdrawal of concessions and the introduction of minimum tariffs.

The major tariff reform package accepted by the present government as part of the Structural Adjustment Program with the International Monetary Fund incorporates many of the principles of reform enunciated by the committee. It envisages a faster program of reduction of tariffs, however, with the maximum tariff brought down to 35 percent (rather than 50 percent, as recommended by the Tariff Reforms Committee) by the beginning of fiscal year 1996–97. The first phase of this reform package has already been implemented in the 1994 Finance Act, which merges para-tariffs into the basic tariff structure; reduces the maximum tariff to 70 percent; withdraws some SROs, including the distinction between commercial and industrial importers; and makes drastic reductions in rates on items prone to smuggling. Neutrality of tax revenues has generally been preserved by the revenue gains from the merger of para-tariffs and the consequent favorable effects on sales tax collections.

The impact on levels of protection has not been very pronounced in the first year of reform because of the merger of para-tariffs. While industries with competitive imports at the maximum tariff rate have experienced some decline, most industries have yet to receive the shock of downward adjustment in tariffs on competitive imports. For the same reason, the impact on the level of imports is unlikely to be significant.

Potential Gainers and Losers

Tariff reforms of the kind envisaged under the ESAF will represent one of the major events in the industrial history of Pakistan, with vital implications for income distribution, many of which have not yet been fully understood. In broad terms, protection levels for a large number of industries will be altered dramatically; some will gain and others will lose. Beneficiaries will include industries where the tariff rate on output will fall less than the tariff rate on intermediate inputs, while the opposite case will apply to losers. There is considerable uncertainty at this early stage of the
reform process about to the industrywide distribution of gains and losses. This uncertainty is partly the consequence of the strategy pursued by the government in implementation of the reforms. The Tariff Reforms Committee had recommended that an open and transparent approach be adopted whereby industry was consulted at every stage, and at the micro level that views be incorporated subject to adherence to the broad principles of reform. It was proposed that model tariff schedules be prepared for each year of the three-year reform period, and circulated in advance to representatives of trade and industry to elicit their views.

This has not happened. Instead, the traditional approach of maintaining total secrecy until the announcement of the Finance Bill has continued. Consequently, there has been a spate of complaints from various industry groups about the emergence of new fiscal anomalies, and the government found it necessary to form a committee to address these problems. Perhaps in the view of the policymakers, the only viable approach is to create a de facto situation, and then handle the fallout. The alternative of an advance announcement of the details of the reform package could lead to the formation of strong coalitions to block the change.

While the strategy adopted may minimize the resistance of losers in the short run, it also carries a risk of failing to mobilize support from potential gainers. Given the complex nature of the tariff reform process and its wide-ranging ramifications, it is clear from a political economy perspective that the active resistance of potential losers has to be traded off against the aggressive and vociferous support of potential gainers. This can only happen, however, if the potential gainers clearly perceive the gains, and are then able to lobby in favor of the reforms.

Serious informational problems also exist with the broad mass of consumers who will benefit from the reduction in the landed costs of imported consumer goods and through a fall in profit margins on smuggled goods because of greater competition from official imports. The government must identify specific cases of price reductions in major consumer items (for example, bicycles and electronic goods) brought about by the tariff reforms and advertise them in the popular press and media to create broad-based support for the change.

One of the key target groups of gainers from the reforms is exporters, who not only benefit in a broad macroeconomic sense from the narrowing of the differential between the effective exchange rate on exports and imports, thus tilting relative profitability in favor of the latter, but also in a more direct and visible manner through the elimination of duties on imports of raw materials, intermediate goods, spare parts, and machinery for export purposes. This coincides with the phasing out of the export rebate regime, however, which had become a mechanism for making large but hidden transfer payments to many exporters. As such, support for tariff reforms from exporters is likely to remain muted.

Since the announcement of the tariff reforms package in the budget speech of 1994–95, there has been a growing recognition of the disequilibrium that this will create in the industrial sector, and a general apprehension that there will be serious dislocation, large-scale plant closure, and labor displacement. The downward adjustment in the maximum tariff rate from 92 percent to 35 percent within three years is seen as too rapid in view of the rigidities in response mechanisms arising from the high costs of capital, union agreements, lack of technology transfer, and the like. In the minds of losers, this reform will contribute, at least in the short run, to a process of deindustrialization in the country, and there will be a flood of imported goods, which will not only lead to a major deterioration in the balance of trade, but will also price out domestic industry. Given that this set of reforms is part of the agreement with the IMF, there is also the perception that the initiative is not indigenous in origin.
Withdrawal of SROs is likely to pose the same problems confronted in the removal of major exemptions from the income tax (discussed earlier). The government will have to contend with the pressure and lobbying powers of powerful special interests. First, the multinationals, which have invested in import-substituting industries with high levels of profitability in a protected market, will be adversely affected by the scaling down of tariffs. This includes sectors such as chemicals, automobiles, and polyester fiber. Second, removal of the preferential treatment given to imports by major public sector importers such as WAPDA, PTC, and OGDC will be strongly resisted on the grounds that this will imply higher project costs and necessitate higher levels of borrowing, while leading to higher utility prices. Third, the case for retention of fiscal incentives such as exemption of import duties on machinery for rural industrialization will be strongly argued at the political level as a means of removing regional disparities. Of course, as tariff levels come down generally, the value of concessions should decrease substantially. The government has recently tended to move in the opposite direction of that required by the tariff reforms, by granting duty concessions for power generation and import tractors.

**Determinants of Success**

The true test of implementation of the reforms will come next year, when by agreement the maximum tariff rate will have to be reduced from 70 percent to 45 percent, with a consequent downward change throughout the tariff schedule, and it will no longer be possible to cushion the impact by merger of para-tariffs.

Success will hinge largely on the government’s ability to orchestrate the process and mobilize support from potential gainers, including specific industries, commercial importers, consumers, and exporters, while introducing safety nets to minimize the social costs of adjustment, including provisions for Social Security, labor re-training, credit for modernization, and the like. It is also of significance to note that up to now resistance has come from owners of industrial capital, but as some industries run into structural problems and there are retrenchments, the trade unions could also launch a protest movement. This will create special problems for the present government, which has a strong vote bank in unions and is sympathetic to labor interests. There will be difficulties in selling the argument—because of the inevitable time lags—that employment will eventually be promoted by the increase in labor-intensive exports.

Implementation problems are also likely to be compounded by the degree of ambivalence and apparent lack of full commitment of agents of state to the tariff reform process. First, there are genuine concerns voiced by the tax administration and the Ministry of Finance about whether the transition can be achieved in a revenue-neutral manner, without exacerbating the already existing problem of the large budget deficit. Reductions in customs duty revenues (of about 3 percent of GDP) will require quantum jumps in revenues from domestic taxes such as the income, sales, and excise taxes. Growth in income tax revenues is limited by the presence of large tax expenditures, described earlier, and the state appears to be captured by special interest groups. Broadbasing of the sales tax will hinge on the level of taxpayer compliance and greater documentation of transactions. Existing excise duty rates are high, and further enhancements could be counterproductive. Also, the federal government could be a major loser, even if overall revenue-neutrality is somehow achieved, given the nature of revenue sharing arrangements whereby customs duties are outside the divisible pool, while income and sales taxes are shared with the provinces (as described earlier).

Second, there is a degree of pessimism with regard to the possibilities of export growth in the short-to-medium run, given the limited product diversification and low quality of Pakistani ex-
ports, the increasingly competitive international environment, and adverse supply-side factors. There is some apprehension that any deterioration in the trade balance will lead to destabilization brought about by cumulative exchange rate depreciation. In broad terms, a strong level of commitment of agents of state to the process of tariff reforms, as part of the overall vision of the government about industrial development, does not appear to exist.

The next two years will determine the success or failure of this package of reforms. The government will have to carefully orchestrate the reforms by playing off gainers against losers. The former will have to be identified through micro-economic research, and their support for reform mobilized. A vigorous public awareness campaign will have to be launched to acquaint the larger population with the immediate and long-term gains from the reforms, including consumer benefits, less corruption and smuggling, and the like. Losers may have to be compensated by establishment of safety nets, including unemployment benefits, credit facilities, and subsidized labor training programs. In the absence of these steps, there is a danger that the tariff reform process may be interrupted by resistance from a broad coalition of industrial and labor interests, as happened with the broad-basing of the GST this year.

Conclusions

This chapter has adopted both a macro-economic and a microeconomic focus to analyze the relationship between governance capacity and successful adjustment. It examines the degree of success or failure in implementing two major elements of fiscal reform in the Pakistani setting, one relating to the introduction of presumptive/withholding taxes as a means of simplifying the tax system and combating evasion, and the other dealing with broad-basing of direct taxes by rationalizing tax expenditures. It also analyses two ongoing reforms relating to broad-basing of the general sales tax and tariff reforms.

The chapter demonstrates that while a government can meet with exceptional success in one area, it can be confronted with ignominious failure in another. The Nawaz Sharif government achieved notable success in extending the network of presumptive/withholding taxes because a number of favorable factors of governance came together, including the projection of the reform as an integral part of the vision of change, demonstration of superiority of the reform to other available actions, building a strong and diversified coalition of support, strong leadership from the top, by placing losers in a negative light, bypassing losers, the presence of credible threats to losers, lack of homogeneity of losers, initial success of reforms, and an opening up of the budget-making process.

In contrast, elimination of tax concessions and exemptions to make the tax system more neutral and fair floundered because of ambivalence toward the reform on the part of agents of state; state capture by special interest groups; lost opportunities for bargaining with potential losers; strong organization and lobbying power of losers as opposed to the dispersed nature, uncertainty of benefits, and lack of information of the gainers; and launching of a successful campaign by losers that the status quo is actually in everybody’s interest.

Similarly, the partial retreat by the Benazir Bhutto government from implementation of reforms in the general sales tax this year reveals how an effective coalition of potential losers can be organized (with street agitation) in the presence
of weak support for the reforms from gainers because of the dispersed, uncertain nature and uneven distribution of gains, and agents of the state with a lack of vision, commitment, and preparedness for the reforms.

The ongoing tariff reforms will require a high level of governance capacity for the careful orchestration of the reforms by skillfully playing off gainers against losers. The imperatives and need for reform have to be successfully demonstrated within the overall vision of industrial development. A vigorous public campaign will have to be launched to acquaint the larger population with the immediate and long-term gains. Support of specific groups of gainers, such as commercial importers, exporters, and consumer groups may have to be mobilized. Compensatory mechanisms will need to be developed for losers, and a more transparent process of negotiations will need to be adopted to create a greater sense of ownership of the reforms.

The next two years will represent a major milestone in the path of fiscal reforms in Pakistan. As part of the ESAF, deep cuts will have to be made in tariffs, and the sales tax extended to one of the most difficult to tax sectors, wholesale and retail trade. The basic question is whether the government will demonstrate the ingenuity and capacity to successfully pilot through these changes.
Bibliography


Uneven Governance and Fiscal Failure: The Adjustment Experience in Turkey

Izak Atiyas

Starting in 1980, Turkey embarked on an ambitious program of stabilization and structural adjustment. The speed with which macroeconomic stability was established and the rapid response of the private sector to the new regime made Turkey a success story among adjusting countries. Turkey has succeeded in liberalizing foreign trade, the financial sector, and the capital account, and in transforming a protected, inward-oriented economy into an export-oriented and private-sector-driven economy with a number of sectors that can compete internationally.

Nevertheless, fourteen years later, in early 1994, Turkey was once again faced with a major macroeconomic crisis, and had to embark on a new stabilization program. The crisis was driven by unsustainable fiscal deficits—overall public sector borrowing requirements (PSBR) reached almost 12 percent of gross national product (GNP) in 1993. The purpose of this chapter is to examine the economic reform experience in Turkey and attempt to explain the factors that led to the failure in fiscal policy.

The main argument of the chapter is that the failure in fiscal policy originates in a failure of governance capacity. The aspect of governance that is most salient in explaining the Turkish experience is the inability of the state to resolve problems of cooperation between political actors. It is argued that the Turkish experience with fiscal policy, or, more specifically, the way state resources are used as an instrument of political competition, lends itself to conceptualization as a problem of cooperation. The likely outcome is the uncooperative one. In the context of competition to acquire or maintain political power, political actors behave in a predatory manner and distribute the resources of the state to political constituencies, causing inflation and macroeconomic instability. In the more desirable outcome, by contrast, political competition is less predatory, has less destructive fiscal implications, and the political actors agree not to resort to "excessive" transfers and subsidies as a means of competition. Given the incentives to deviate into uncooperative behavior, however, the realization of this more desirable outcome requires either the existence of norms that restrain predatory behavior or mechanisms that allow the actors to commit themselves not to deviate. The governance failure is associ-
ated with the absence of the norms and mechanisms that would support cooperative outcomes.

The absence of such norms and mechanisms preceded the period of economic reform. Indeed, the inability of the mainstream political actors to reach compromises and to cooperate to resolve fundamental problems facing the country was an important factor in the economic and political crisis that afflicted Turkey in the 1970s. It seems that the failure is partially associated with a party structure that is excessively sensitive to the particularistic demands of constituencies. In any case, it is argued that this deficiency in governance was not addressed by governments that pursued economic reform in the 1980s. Instead, the centralization of governmental authority and an increase in the discretion over state resources during this period probably aggravated the problem of cooperation.

The existence of such a governance gap has important implications for the conduct of macroeconomic policy. One of the conclusions of the chapter is that a sustained resolution of the problem of macroeconomic instability may require structural reforms that change the way the state manages distributional conflicts in society. It is argued that in the case of Turkey, attempts to establish macroeconomic stability by suppressing distributional demands temporarily, without undertaking such structural reforms, has preserved the vulnerability of the fiscal accounts to the process of political competition.

This failure, however, was coupled with considerable success in another dimension. By the end of the 1980s there was a wide consensus in the country that the preferred model of economic development would be predominantly market-oriented; the country would not be isolated, but instead would become increasingly integrated with the rest of the world. Moreover, there has been a significant change in the business culture: on the one hand, entrepreneurial activity is more appreciated. On the other, protectionist demands from industry find less support from public opinion.

This chapter argues that this consensus builds an irreversibility into economic reform and discusses the contribution of Ozal, the main architect of economic reform and the head of the government during the reforms of the 1980s, in the development of this consensus.

This combination of factors puts Turkey in an interesting situation. Fifteen years of reform have created a vibrant private sector, and a state that is lagging behind in attending to important regulatory and social functions. Having reformed the aspects of the economy that relate to the economic activities of the private sector, it seems that the majority of the remaining tasks have to do with reforming the state.

The rest of the chapter is organized as follows. The next section provides a brief historical background. The third section describes the stabilization and adjustment program and documents the fiscal deterioration. The fourth section discusses the governance aspects of the stabilization and adjustment period. The fifth section concludes the chapter.

The State, the Economy, and Party Politics before 1980

During the first two decades of the Republic, political power in Turkey was monopolized by the Republican People's Party (Cumhuriyet Halk Partisi, CHP), which represented a coalition of military-bureaucratic elites at the center, and traditional notables of the otherwise disconnected periphery. Because of the devastating impact of the Great Depression in 1929 and the perception that the weak entrepreneurial base, concentrated mainly in commerce and dependent on foreign markets, could not promote structural transformation and industrialization, the 1930s witnessed a systematic effort of state-led social change. In the realm of economic policy,
this entailed an array of state activities, including imposition of exchange controls, major public investments in manufacturing, nationalization of foreign and local companies delivering public services, and imposition of import duties and quotas to protect industry. Private manufacturing started to develop under the tutelage of the state, and with the active participation of the bureaucracy (Keyder 1987).

The transition to multiparty politics occurred in 1945, when the CHP allowed the formation of an opposition party, the Democratic Party (Demokrat Parti, DP). The introduction of political competition and the ascendance to political power of the newly formed DP in 1950 represented a milestone in the country’s political and economic development. With the introduction of political competition, peripheral social groups, especially the peasantry, were actively courted by political parties, particularly the DP, for the first time. The political system became sensitive to the demands of diverse groups, especially those in the rural areas, creating incentives for these groups to participate in the political process. Whereas during the single-party era patronage was a form of exchange between the state and local notables and did not entail the active participation of peasants in the political process, political competition enabled peasants to acquire power and to bargain for services. Although the leadership of the DP was from the central elite, instrumental in their succession to political power was their ability to forge and mobilize a wide-ranging coalition of landed interests, small peasantry, and urban mercantile groups. The DP advocated political liberalism and promised an end to the oppressive reach of the state. An appeal to religious sentiments found resonance, especially in rural areas alienated by the top-down secularism of the CHP (Sunar and Sayari 1986, p. 173).

The multiparty system and political competition created incentives to use the resources of the state to win political support. Political parties, especially their local organizations, became avenues for deals exchanging support during elections for a variety of benefits, ranging from employment in the public sector, roads, credit, waterways, and “political factories” to purely personal assistance in alleviating the burdens of bureaucratic red tape. Political entrepreneurship—the ability to represent the interests of constituents in party organizations, and in local and even national political and administrative forums, and the ability to make deals with constituents—became a critical trait for success in politics. With accelerating migration to the cities, particularly after the 1950s, patronage networks in urban settings became very important elements of the political process as well. ¹

The DP was more liberal in its economic policy than the CHP; it came to power as the representative of deeply rooted antibureaucratic sentiment. While the 1950s witnessed a booming private sector, however, the scope of state intervention did not diminish significantly.² If anything, perhaps the political principles guiding the allocation of resources commanded by the state changed to allow the newly represented groups to receive a larger share, and the logic of political competition gained prominence.³

In 1960 the DP regime was overthrown with a coup. The new Constitution envisaged “planned development,” and the State Planning Organization was formed. Political power was soon trans-

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¹ See Sayari 1977; Sunar 1990, forthcoming; and Sunar and Sayari 1986 for discussions of patronage systems in Turkey and their link to the development of the multiparty system. Leder (1977) discusses the impact of political competition in rural areas. Karpat (1974) traces the development of the political entrepreneur in the urban shantytowns.

² The DP experimented with a more liberal import regime in the early years of its rule, but returned to rigid import controls by 1955.

³ Keyder (1987) describes Menderes, the leader of the DP and the prime minister, in the following way: “he seemed to despise the ordinary constraints of accounting and was endlessly inaugurating public works projects without regard to cost” (p. 134). These were financed through the Central Bank, which in turn caused a doubling of prices between 1955 and 1959.
ferred to civilians. The center-right Justice Party (Adalet Partisi, AP) became the inheritor of the DP tradition, while the CHP gradually came to resemble a social democratic party. The two competitors differed in the emphasis to be placed on growth and equity and the desired sizes of the private and public sectors of the economy, but at least until the late 1970s there was a consensus among the main political actors on the basic premises and soundness of what has been called import-substituting industrialization (ISI). The goal of industrialization was paramount, and it was supported by business and labor. In the Turkish version of the ISI, almost no economic group was left out, and each obtained something from the state. Business and labor participated as the agents of industrialization. Peasants participated because they had the power to vote.

The consensus over ISI entailed a large extent of state intervention: state-owned banks allocated subsidized credit to the private sector, especially to industry and agriculture. While state economic enterprises (SEEs) were originally conceived as the main engines of industrialization in the 1930s and 1940s, when the private sector was very weak, over time they came to play a crucial role in the development of the private sector. They were dominant in the production of critical intermediate inputs, such as chemicals and petrochemicals, which were sold to the private sector at subsidized prices. They were also instrumental in subsidizing agriculture through the production and subsidized allocation of fertilizers. Finally, they were an important source of employment for surplus labor.

Import licenses were another significant source of rents for the private sector. Import-substituting private industry thus benefited from protection, from the rents associated with the quantitative restrictions that characterized the import regime, subsidized inputs, various forms of fiscal incentives, and subsidized financial resources. The agricultural sector, in addition to receiving subsidized credit, also benefited from support prices—which, on average, surpassed world prices—and subsidized fertilizers and seeds.

For business, personal contacts with members of the cabinet or with the bureaucracy have been important for access to incentives, subsidized credit, and government contracts. Apart from personal contacts by leading entrepreneurs, business associations have generally been weak in exerting direct influence on the policymaking process (Bugra 1994; Onis and Webb 1994). Nevertheless, these associations were influential as voting blocks in elections. The voting power of small business and agriculture probably explains the very narrow tax base of public revenues in Turkey, as well as persistent efforts of the center-right parties to dominate the elections of business associations.

In agriculture, the predominance of small-holdings precluded direct influence on the government or its ministers. The main channels of influence were elections, local party congresses, and contacts with local party leaders. To the extent that organizations existed, their survival and any influence they had was mainly the product of the center-right parties', especially the AP's, establishment of control over these groups by placement of party sympathizers in their governing bodies (Erguder 1981, 1991).

The transition to multiparty competition affected the bureaucracy as well. The CHP regime had cultivated a bureaucratic elite, one that was loyal to the mission of state-led modernization and Westernization. It evolved to see the formulation of public policy as its legitimate responsibility, and it did not have a conception of public interest that would arise out of a competitive political process: "Thus, it was a responsibility of the bureaucrats to carry out public services on the basis of 'objective' criteria, and not in accordance with the 'whims' and 'illegal' interventions of the politicians" (Heper 1990, p. 609; see also Heper 1987, 1989). The bureaucratic elite also saw itself as the guardian of "Kemalism" and its statist orientation toward public policy, and viewed the new politi-
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A variety of reasons have been proposed to explain the failure of governance that increasingly characterized the 1970s. Such explanations have included the emergence of new cleavages generated by the immense social transformation of Turkey as a result of rapid economic development; a tendency among political leaders to see political power as absolute; and the attempts of the mainstream parties to counter competition from new, radical groups, both on the right and the left (see Erguder 1988; Ozbudun 1988; Turan 1988). What is especially interesting for the purposes of this chapter is that the combination of the state’s discretionary command over a large amount of resources and a party system that became extremely responsive to the localized and particularistic demands of its constituencies inhibited the political system’s ability to address matters of public policy. The first component of this combination is straightforward, but the second may require further exploration.

By the end of the 1970s, on the eve of the adoption of a major program of structural adjustment and a military takeover, Turkey was in a deep economic and political crisis. There was a severe crisis of governance. The party system had become polarized and fragmented, leading to weak governing coalitions at the mercy of small parties. As new and more ideologically oriented parties emerged, the mainstream parties on the right and the left became unable to cooperate sufficiently to address some of the basic problems afflicting the country—most notably, the need to curb political violence and to find solutions to a mounting balance of payments crisis. The inability of the parties in the center-right and center-left to cooperate allowed ideologically oriented parties to bargain for political power incommensurate with their electoral power (Erguder 1988, pp. 122, 124).

Changes in governments were followed by major reshuffling of the civil service. The civil service also became weak financially, and real salaries declined significantly over the years, which discouraged talented people from joining the bureaucracy. The bureaucracy, in turn, tried to protect its power by engaging in “pathological bureaucratization” (the term is from Heper 1977, p. 80)—policies imposed by governments would be sabotaged in a maze of rules and regulations.

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This excessive sensitivity has been noted by many political scientists in Turkey, and its origins are likely to lie in the particulars of the patronage system that developed in response to the introduction of political competition. It seems that in addition to the dynamics of interparty competition, patterns of intraparty competition and bargaining also played a role. Standing as a candidate for parliamentary elections depended on the candidate’s ability to obtain the support of party delegates at the subprovincial level, where support was made available in return for contingent claims on various benefits if the candidate was successful in the elections. The delegates acted as “brokers” between the party and the constituency, and they were appointed by the party leaders because they could mobilize constituencies, provided, of course, that the broker himself could

4 Gunes-Ayata (1994, p. 36) calls this the “subservience” of party officials.
deliver to the constituencies. To honor the liabilities, the candidate relied on the party leadership. While this granted substantial authority to the leaders of government parties, as well as an ability to control the actions of their deputies, the same mechanism implied that the maintenance of leadership status was contingent on the government's ability to cater to the liabilities; the deputy could defect if the party leadership failed to grant the service. Party leaders, including those in the government, became preoccupied with keeping their parties together, rather than attending to pressing public policy. The legislature ceased to be an institution of deliberation and legislation, and was in constant stalemate.  

The domination of constituency concerns over others in the behavior of the legislators affected the functioning of the GNA [Grand National Assembly, the Parliament] in several ways: First, many of the sessions of the legislature could not start because most legislators were so busy that they could not attend sessions, usually making it impossible for a quorum to obtain.

Second, parliamentary duties turned into instruments which a deputy used for the exclusive advancement of his own career. For example, a position on the committee on State Economic Enterprises, which is supposed to exercise oversight on the activities of these institutions, became a channel through which jobs could be found for constituents. Membership in the Committee of the Budget and Economic Planning became an arena where, mostly, pet constituency projects could be pushed. In summary, the Parliament became a grand-spoils operation, little concerned with other functions. [Turan 1988, p. 91]

It seems that the system suffered from a severe public goods problem: whenever a given liability was honored, all the benefits accrued to the specific constituency, but the cost (ultimately macroeconomic disequilibria and inflation) was socialized. This created an incentive to overspend. The institutional structure of fiscal expenditure management conformed to the political necessities. Information flow was extremely poor, and there was no system to monitor the efficiency of fiscal expenditures. The Central Bank was essentially subordinated to the government: fiscal deficits were financed mainly through monetary expansion, and the system also entailed substantial quasi-fiscal subsidies distributed by the Central Bank and state-owned banks.

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**Table 1: Macroeconomic Indicators**

<table>
<thead>
<tr>
<th>Year</th>
<th>GNP Growth</th>
<th>Industry Growth</th>
<th>Change in Wholesale Price Index</th>
<th>PSBR/PSBR-GNP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>2.9</td>
<td>6.6</td>
<td>52.6</td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>-0.4</td>
<td>-5.6</td>
<td>63.9</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>-2.3</td>
<td>-6.0</td>
<td>107.2</td>
<td>10.5</td>
</tr>
<tr>
<td>1981</td>
<td>5.3</td>
<td>7.4</td>
<td>36.8</td>
<td>4.9</td>
</tr>
<tr>
<td>1982</td>
<td>3.7</td>
<td>4.9</td>
<td>25.2</td>
<td>4.3</td>
</tr>
<tr>
<td>1983</td>
<td>4.6</td>
<td>8.0</td>
<td>30.5</td>
<td>6.0</td>
</tr>
<tr>
<td>1984</td>
<td>7.8</td>
<td>10.1</td>
<td>50.3</td>
<td>5.3</td>
</tr>
<tr>
<td>1985</td>
<td>4.5</td>
<td>6.3</td>
<td>43.2</td>
<td>3.5</td>
</tr>
<tr>
<td>1986</td>
<td>7.5</td>
<td>8.8</td>
<td>29.6</td>
<td>3.6</td>
</tr>
<tr>
<td>1987</td>
<td>9.3</td>
<td>9.5</td>
<td>32.0</td>
<td>6.1</td>
</tr>
<tr>
<td>1988</td>
<td>1.5</td>
<td>3.2</td>
<td>70.5</td>
<td>4.8</td>
</tr>
<tr>
<td>1989</td>
<td>0.9</td>
<td>3.1</td>
<td>64.0</td>
<td>5.3</td>
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<tr>
<td>1990</td>
<td>9.8</td>
<td>9.0</td>
<td>52.3</td>
<td>7.6</td>
</tr>
<tr>
<td>1991</td>
<td>0.5</td>
<td>2.7</td>
<td>55.3</td>
<td>10.3</td>
</tr>
<tr>
<td>1992</td>
<td>6.4</td>
<td>6.8</td>
<td>62.1</td>
<td>10.6</td>
</tr>
<tr>
<td>1993</td>
<td>8.1</td>
<td>8.7</td>
<td>58.4</td>
<td>11.7</td>
</tr>
<tr>
<td>1994</td>
<td>-6.0</td>
<td>-3.9</td>
<td>120.7</td>
<td>8.2</td>
</tr>
</tbody>
</table>


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5. The Parliament's inability to elect a president in 1980 was one of the most visible indicators of its failure to function.
Another important characteristic of the system was that it made political cooperation between different parties difficult. The increasing inadequacy of cohesion within the parties and the need of political leaders to juggle to cater to party members made it difficult to bargain successfully with other party leaders. Difficulty in cooperation exacerbated the public goods problem mentioned above, and with it, fiscal and quasifiscal balances.

The economic performance of the system was, on average, quite satisfactory until 1977. There were several instances of balance of payments problems, but they were resolved without straining the boundaries of the ISI framework. Between 1950 and 1975 real GNP increased about 4.5 times (an average growth rate of 6.2 percent). The economy went through significant structural change; the share of industry in gross domestic product (GDP) increased from 11 percent in 1950, to 18 percent in 1965, and to 22 percent in 1975. Growth was inward-oriented; between 1975 and 1980 the export/GNP ratio was less than 5 percent.

When the first oil shock hit in 1973, Turkish policymakers responded to the worsening current account deficits by running down reserves and borrowing abroad. Expansionary policies continued. The currency remained overvalued, and by 1979 international reserves were depleted. Lack of foreign exchange crippled industrial production (see table 1).

Successions of coalition governments did not exhibit any capacity to deal with the political or the economic crisis. Two stand-by agreements with the IMF, in 1978 and 1979, failed because the government was unable to curb expenditures. In November 1979, the AP came to power and Demirel became the prime minister. On January 24, 1980, the government launched a program of economic stabilization and liberalization. The architect of the program was Mr. Ozal, a former civil servant at the State Planning Organization (SPO). Political and social instability continued. The military took over in September 1980. The Parliament was dissolved, and all political parties were closed down. This represented a grand bargaining failure between the mainstream parties on the right and the left, the AP and the CHP. These were the parties that had the most interest in preserving democracy and cooperating to find viable solutions to the economic and political crisis. They failed.

The Adjustment Period

The military takeover changed the rules of the political game. The Parliament was dissolved, and all political parties were closed down. Union activity was suspended. Nevertheless, there was continuity in economic policy. The military government retained Ozal and granted him the main responsibility for conducting economic policy. Following a banking crisis in 1992, Ozal and his team resigned. The break was brief, and in 1983 Ozal returned as prime minister.

As emphasized by Onis (1992, p. 11), the military regime enjoyed legitimacy and support because it was seen as a temporary solution to the governance crisis that had gripped the country, especially because the military was successful in restoring law and order. Nevertheless, the return of Turkey to fully competitive politics with no entry barriers was gradual, and a brief summary here will be useful. First, general elections took place in 1983. The military allowed only a small number of parties to participate in the
elections. Former political leaders were banned from participating in politics. Two of the parties that ran in the 1983 elections, one on the right and one of the left, were led by former soldiers and supported by the military. The third, the Motherland Party (Anavatan Partisi, ANAP), was led by Ozal himself. ANAP easily won the elections and Ozal became the prime minister.

Other parties eventually were allowed to form. On the right, the Great Turkey Party (Buyuk Turkiye Partisi, BTP) was formed in 1983, and was identified as the continuation of the AP. It was closed down by the military in the same year. The AP tradition was then picked up by a new party, the True Path Party (Dogru Yol Partisi, DYP). On the left, the Social Democracy Party was formed. This later was merged with the Populist Party to form the Social Democratic Populist Party (Sosyal Demokrat Halkci Parti, SHP).

The intensity of political competition dramatically increased after the banned leaders were given the right to engage in politics in a 1987 referendum. Demirel and Ecevit, the former leader of the CHP, and about 100 other politicians reentered the political arena. The majority in the referendum was a slim 100,000 votes. Soon after the referendum, in the general elections of November 1987, ANAP received 36 percent of the votes and, thanks to the electoral law, 63 percent of the seats in the Parliament. After that, electoral support for ANAP decreased. During the local elections of March 1989, ANAP’s share dropped to 22 percent, and it emerged as the third party. ANAP lost the general elections in 1991, and Demirel, as the leader of the True Path Party, became the prime minister in a coalition government formed with the left-of-center SHP.

Throughout this period there were no fundamental divergences from the main trend in economic policy, which was to progressively reduce controls over private sector economic activity, reduce protection from imports, enhance export orientation, and increase Turkey’s integration into the world economy. Indeed, as will be stressed in the next section, a consensus emerged that Turkey’s future lay in an economic regime that was fundamentally different from the ISI. In apparent contradiction of this general trend, the weight of the public sector in the economy did not diminish. In the context of intensifying political competition, deficits in the public sector remained a particularly intractable problem, endangering macroeconomic stability. The next three sections will review the political dynamics behind fiscal deterioration.

Economic Reform: An Overview

The January 24 economic reform program had ambitious objectives. The program envisaged nothing less than a fundamental change in the mode of economic development, from a protected, inward-oriented approach with extensive state regulation and intervention in many areas of the economy to a stance that was export-oriented, with the private sector as the main engine of growth.

The initial stabilization package included a steep devaluation, price deregulation for industrial products produced by the private sector, and large increases in the prices of SEE products. Interest rates were deregulated in June 1980. Initial attempts at trade liberalization were undertaken in 1981. By 1982, the public sector borrowing requirements as well as the rate of inflation were reduced, and the economy resumed growth.

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The outstanding aspect of growth was its export orientation—between 1980 and 1982 the exports/GNP ratio doubled, to 10 percent.

With Ozal's return as prime minister in 1983, economic reform proceeded at full speed, and the next few years witnessed reforms in diverse areas. In the financial sector, banking deregulation was accompanied by better supervision; a foreign exchange market, a stock exchange, and an interbank market were created. Foreign exchange transactions were deregulated, and the capital account was liberalized in 1989 (for details, see Atiyas and Ersel 1994). In the area of foreign trade, in addition to the sustained real depreciation of the currency, there were two important trends.\(^9\) The first was the liberalization of imports. Negative import lists were replaced by positive lists in 1983–84. By 1988 only thirty-three items were subject to any import licensing; quantitative restrictions were thus effectively eliminated. Tariffs and other surcharges on imports changed frequently, but there was a general reduction in these as well: unweighted average tariffs decreased to 11 percent (17 percent for consumer goods) by 1989 (Onis and Webb 1994, table 5-5).

The second important policy tool used in the trade area was the export incentive. In the pre-reform regime, exports were discouraged both by overvalued exchange rates and by protection from imports. In order to encourage exports, the government supplemented real depreciation of the Turkish lira with an array of incentives (Krueger and Aktan 1992; Rodrik 1993). These included provisions for foreign exchange retention, tax rebates (later reduced, and eventually phased out in 1989), export credits (with interest rates much lower than the very high commercial rates), foreign exchange allocation schemes, corporate tax reductions, and subsidies from a Support and Price Stabilization Fund. Exporters whose annual export volumes were above a minimum level were rewarded with additional tax rebates. These special incentives were instituted to promote large trading companies (Onis 1992), and they were eliminated in 1989. The amount of resource transfer effected by these incentives was substantial. According to Togan, nominal subsidies (net of indirect taxes) averaged about 32 percent of total exports in 1983, and 24 percent in 1984; they declined to 16 percent in 1989 and to 13 percent in 1990. Yeldan (1994) calculated that between 1982 and 1992, export subsidies were substantially higher than total corporate taxes collected by the government for all years except 1986, when they were almost equal. Arslan (1993) calculates that between 1988 and 1991 the fiscal cost of export incentive programs ranged between 2.0 and 2.4 percent of GNP.

Fast growth in exports became one of the most important yardsticks of the success of the adjustment program. Between 1980 and 1990, the value of exports increased from US$2.9 billion to US$13.0 billion. The share of manufactured goods in total exports increased from 29 to 72 percent.

The weakest component of the adjustment effort was macroeconomic stability. A major element of stabilization in the early 1980s was a significant retrenchment in the public sector. The public sector borrowing requirements (PSBR) were reduced from almost 9 percent of GNP to 4 percent between 1980 and 1981 (table 1). This drastic reduction was achieved by cutting both the deficit of the central government budget and SEE losses. In the case of the consolidated budget, major reductions were made in personnel expenditures and transfers to SEEs. In the case of the SEEs, the main sources of the decrease were the deregulation of the prices and a relative decrease in wages and salaries (see Celasun 1990 for a review of fiscal policy in this period).

A second important component of the decline

\(^{9}\) For details of trade reform see Baysan and Blitzer 1990, 1991; and Krueger and Aktan 1992.
in SEE borrowing requirements was a reduction in subsidies allocated to agriculture. (The role of SEE's in Turkish agricultural policy will be discussed in more detail below.)

The initial reduction was generally maintained until the mid-1980s, with an average PSBR/GNP ratio of 4 percent in 1980-86. The first significant jump occurred in 1987 as a result of the fiscal expansion associated with the election year, and the economy recorded an extraordinarily high growth rate of 9.3 percent. This was followed by a minicrisis, and a stabilization program was initiated in February 1988. The PSBR ratio then increased on a sustained basis until it hit a record 11.7 percent in 1993, followed in 1994 by a major crisis, a stabilization effort, and a record 6 percent drop in GNP (table 1). Below it will be argued that the deterioration in the public accounts was closely linked to increased redistributive pressures on government finances. Before that, a closer look at the origins of these pressures in the labor markets and agriculture will be useful.

**The Limits of Income Redistribution**

The stabilization and adjustment effort of the early 1980s entailed major redistributions of income. There were two conspicuous losers—labor and agricultural producers. In both cases, the political environment in the early 1980s was instrumental in affecting the redistribution of income. The more militant of the two largest trade unions, DISK, was dissolved by the military government. While the other, Turk-Is, continued under military rule, it operated under extremely restrictive rules laid down by the military government. The government ended strikes and banned union activity. Collective bargaining was replaced by the deliberations of the High Arbitration Board, which was controlled by the government. Moreover, the new Constitution banned unions from engaging in political activity or supporting or receiving support from political parties. The resulting decline in real wages was one of the basic pillars of the stabilization effort. For the economy as a whole, the downward flexibility of wages facilitated the real depreciation that was required for outward orientation. For the public sector, it facilitated the fiscal retrenchment that occurred in the early 1980s.

In the case of agriculture, the suspension of political competition eliminated the main channel of influence that traditionally had served as the vehicle to obtain subsidies from the state. The main channel of influence for agricultural producers, local party organizations, disappeared when the political parties were banned. Moreover, in the early 1980s new parties were formed that did not have the extensive organizations characteristic of the parties active prior to the military takeover. Finally, ANAP did not attempt to build up a rural constituency. The outcome was that there were significant reductions in both the number of commodities subject to support purchases and the real level of support prices offered to farmers. This eliminated one of the most important instruments of income redistribution in the sector.10

The opening up of the political regime in the mid-to-late 1980’s fundamentally changed the environment for macroeconomic policy. Collective

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10 The extent of the redistribution of income away from workers and farmers in the early 1980s has been documented by many scholars (including Boratav 1990; Celasun 1989; Celasun and Tansel 1993). In the case of labor income, this is captured by both a decreasing share of wages in national income and a significant decline in indexes of real wages and salaries. The share of the agricultural sector as a whole in GNP has declined. The relative decline in agricultural incomes is also captured by reductions in various indexes that reflect terms of trade (for example, between agricultural inputs and outputs, and between agricultural commodities and agroindustry products).
Uneven Governance and Fiscal Failure: The Adjustment Experience in Turkey

bargaining was reinstituted in 1987 as part of the trend of redemocratization. In the spring of 1989, right after local elections in which ANAP, the governing party, lost, collective bargaining between Turk-Is and various SEEs, involving 600,000 workers, reached a deadlock. Workers were requesting a wage increase of 170 percent to compensate for the real wage losses of the previous decade. After protracted negotiations, strikes, and other protest activities, the government agreed to an average increase of 142 percent (Milliyet, May 18, 1989).11

Strikes were not the only reason labor was successful at the bargaining table. A very important additional factor was that public opinion and the press (and even employers) were extremely favorably disposed toward labor’s plight (Cizre-Sakallıoğlu 1991, pp. 67, 68). Labor appealed to the public’s sense of fairness, and successfully and credibly argued that they had suffered tremendously from the economic policies of the 1980s. Newspapers were filled with stories of hardships that workers faced to make ends meet. Labor’s demands were generally accepted as overdue and legitimate.12

The whole scenario was repeated two years later, this time with the miners of the Hardcoal Agency in Zonguldak in the lead role. The Hardcoal Agency has been one of the largest loss makers in the SEE sector. When about 100,000 workers decided to travel on foot from Zonguldak, a northern city on the Black Sea, to Ankara in order to talk to the authorities and press their demands, a public opinion poll conducted by the Turkish Daily News found that about 85 percent of the respondents supported the strike as well as the march of the miners.

The increase in public sector wages increased the gap between public sector wages and salaries, and led the government to adjust civil servant salaries in the public sector as well. In July 1989, two months after the conclusion of collective bargaining involving SEE workers, civil servants’ net salaries were increased by an average of 80 percent for the second half of 1989. The result was that a persistent trend of declining public sector wages and salaries was reversed in 1989, as shown in table 2.13

---

**Table 2**

**Changes in Real Wages and Salaries**

<table>
<thead>
<tr>
<th>Year</th>
<th>(1)</th>
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<th>(3)</th>
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<tr>
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<td>100</td>
<td>100</td>
</tr>
<tr>
<td>1982</td>
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<td>74</td>
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<td>78</td>
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<td>1986</td>
<td>76</td>
<td>54</td>
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<td>1987</td>
<td>86</td>
<td>55</td>
<td>87</td>
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<tr>
<td>1988</td>
<td>81</td>
<td>46</td>
<td>82</td>
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<tr>
<td>1989</td>
<td>107</td>
<td>64</td>
<td>117</td>
</tr>
<tr>
<td>1990</td>
<td>124</td>
<td>83</td>
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</tr>
<tr>
<td>1991</td>
<td>186</td>
<td>122</td>
<td>150</td>
</tr>
<tr>
<td>1992</td>
<td>181</td>
<td>130</td>
<td>150</td>
</tr>
<tr>
<td>1993</td>
<td>194</td>
<td>141</td>
<td>160</td>
</tr>
<tr>
<td>1994</td>
<td>n.a.</td>
<td>133</td>
<td>128</td>
</tr>
</tbody>
</table>

n.a. Not available.

Note: (1) index of real gross wages in the private sector; (2) index of real gross wages in the public sector; (3) index of real cost of civil servants’ salaries.

Source: SPO; 1994 Annual Program.

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11 OECD’s estimate of the wage increase in the public sector is lower (112 percent). See OECD 1991.
12 Young labor leaders’ ingenious techniques to appeal to public opinion probably also played a role in generating this sympathy. Rather than resorting to a discourse based in the language of class conflict, which was generally the case in the labor protests of the 1970s, labor appealed to a sense of fairness and paternalism, with an added twist of dark humor. In one province, vast numbers of workers applied collectively to courts for divorce because, as they put it, they were disgraced for not being able to take care of their families. Workers went to work barefoot because, they said, they did not have the means to buy shoes. Growing a beard, boycotting meals, and paying collective medical visits to doctors were other typical acts of protest. The press characterization of these activities as “nonviolent” or as “passive resistance” reflected a sense of empathy in the public, if not one of support.
13 The reader should be cautioned that indexes of real wages and salaries do not reveal that civil servant salaries are, on average, much lower than wages of public sector workers.
The burden of salary increases on the budget was aggravated by significant increases in the number of personnel. Data on actual employment in the civil service are not available, but there are data on the number of staff positions in the public sector, irrespective of whether these positions are occupied or not. Although not perfect, the data are very revealing, because they underscore the extent of patronage in the public sector. During the early years of economic reform, the number of staff positions increased only marginally, and was kept below 1.20 million until 1983 (table 3).

Table 3
Staff Positions in the Civil Service
Thousands

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<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td>Number of positions</td>
<td>1,170</td>
<td>1,170</td>
<td>1,176</td>
<td>1,196</td>
<td>1,286</td>
<td>1,317</td>
<td>1,356</td>
<td>1,491</td>
<td>1,507</td>
<td>1,518</td>
<td>1,541</td>
<td>1,600</td>
<td>1,650</td>
<td>1,811</td>
<td>1,812</td>
</tr>
<tr>
<td>Percent increase</td>
<td>-</td>
<td>-0.1</td>
<td>0.6</td>
<td>1.6</td>
<td>7.5</td>
<td>2.4</td>
<td>3.0</td>
<td>10.0</td>
<td>1.1</td>
<td>0.7</td>
<td>1.6</td>
<td>3.8</td>
<td>3.1</td>
<td>9.8</td>
<td>0.1</td>
</tr>
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</table>

Source: Undersecretariat of Treasury and Foreign Trade Main Economic Indicators, March 1994.

Table 4
Price Support for Selected Products, 1979–93

<table>
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<tr>
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</tr>
</thead>
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<tr>
<td>Wheat</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production price, TL/ton</td>
<td>5,020</td>
<td>10,220</td>
<td>18,740</td>
<td>22,950</td>
<td>28,980</td>
<td>46,670</td>
</tr>
<tr>
<td>Reference price, TL/ton</td>
<td>4,452</td>
<td>11,794</td>
<td>19,123</td>
<td>28,038</td>
<td>34,888</td>
<td>59,769</td>
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<tr>
<td>Price support, TL mn</td>
<td>7,876</td>
<td>-20,565</td>
<td>-5,156</td>
<td>-71,320</td>
<td>-77,604</td>
<td>-180,433</td>
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<tr>
<td>Percent support</td>
<td>12.8</td>
<td>-13.3</td>
<td>-2.0</td>
<td>-18.1</td>
<td>-16.9</td>
<td>-21.9</td>
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<tr>
<td>Coarse grainb</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production price, TL/ton</td>
<td>5,646</td>
<td>8,935</td>
<td>14,365</td>
<td>17,043</td>
<td>22,059</td>
<td>44,009</td>
</tr>
<tr>
<td>Reference price, TL/ton</td>
<td>4,192</td>
<td>9,678</td>
<td>16,209</td>
<td>18,451</td>
<td>27,904</td>
<td>46,636</td>
</tr>
<tr>
<td>Price support, TL mn</td>
<td>8,394</td>
<td>-4,187</td>
<td>-11,243</td>
<td>-8,390</td>
<td>-35,779</td>
<td>-18,607</td>
</tr>
<tr>
<td>Percent support</td>
<td>34.7</td>
<td>-7.7</td>
<td>-11.4</td>
<td>-7.6</td>
<td>-20.9</td>
<td>-5.6</td>
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<tr>
<td>Sugarbeetb</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production price, TL/ton</td>
<td>1,420</td>
<td>3,100</td>
<td>4,580</td>
<td>5,860</td>
<td>6,750</td>
<td>8,960</td>
</tr>
<tr>
<td>Reference price, TL/ton</td>
<td>1,063</td>
<td>4,992</td>
<td>5,735</td>
<td>4,920</td>
<td>6,613</td>
<td>7,840</td>
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<tr>
<td>Price support, TL mn</td>
<td>2,915</td>
<td>-21,373</td>
<td>-12,204</td>
<td>11,374</td>
<td>1,679</td>
<td>11,833</td>
</tr>
<tr>
<td>Percent support</td>
<td>33.6</td>
<td>-37.9</td>
<td>-20.1</td>
<td>19.1</td>
<td>2.1</td>
<td>14.3</td>
</tr>
<tr>
<td>Cotton</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production price, TL/ton</td>
<td>66,000</td>
<td>134,000</td>
<td>177,000</td>
<td>218,000</td>
<td>370,000</td>
<td>510,000</td>
</tr>
<tr>
<td>Reference price, TL/ton</td>
<td>53,229</td>
<td>128,563</td>
<td>144,392</td>
<td>179,210</td>
<td>244,368</td>
<td>442,675</td>
</tr>
<tr>
<td>Price support, TL mn</td>
<td>6,079</td>
<td>2,719</td>
<td>15,913</td>
<td>18,968</td>
<td>65,580</td>
<td>39,048</td>
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<tr>
<td>Percent support</td>
<td>24.0</td>
<td>4.2</td>
<td>22.6</td>
<td>21.6</td>
<td>51.4</td>
<td>15.2</td>
</tr>
</tbody>
</table>

a. (Production Price-Reference Price)/Reference Price.
b. Reference price is calculated by the author from production price, quantity of production, and price support.
Source: OECD 1994b.
Then, during the year of local elections, it increased by an unusually high 7.5 percent, to 1.29 million. The next big jump occurred in 1987, the year of general elections, and the number of positions increased by 10 percent. After marginal increases in 1988–90, the next significant increases were recorded before and after the general elections of 1991. By 1994, the number of staff positions reached 1.8 million, almost 55 percent higher than in 1980.

The wage settlements in the public sector also affected those in the private sector, where the declining trend was also reversed after 1988 (see table 2). There was, however, one important difference in the way the private and public sector industries responded to the change in the relative price of labor. In the early 1990s, following the real wage shock, many industries in the private sector undertook significant restructuring, shedding labor, updating equipment, and increasing productivity. No such restructuring took place in the public sector, because the political costs of layoffs were perceived as prohibitive.

In agriculture, the return of competition to the political process made agricultural subsidies, particularly support prices, prominent instruments in mobilizing votes in the countryside once again. Although initially ANAP was not interested in developing an agricultural constituency, the emergence of DYP, which inherited AP’s networks in the countryside, pushed ANAP to participate in the traditional game of using agricultural policy

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<td>62,450</td>
<td>79,030</td>
<td>96,760</td>
<td>168,090</td>
<td>327,650</td>
<td>50,370</td>
<td>762,590</td>
<td>1,155,910</td>
<td>1,850,000</td>
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<tr>
<td>68,723</td>
<td>74,564</td>
<td>70,442</td>
<td>102,656</td>
<td>245,748</td>
<td>427,873</td>
<td>44,190</td>
<td>96,355</td>
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<td>–86,380</td>
<td>–68,729</td>
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<td>1,086,653</td>
<td>1,250,225</td>
<td>5,399,783</td>
<td>2,997,200</td>
<td>3,248,739</td>
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<td>–9.1</td>
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<td>37.4</td>
<td>63.7</td>
<td>33.3</td>
<td>17.6</td>
<td>72.2</td>
<td>19.4</td>
<td>11.5</td>
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<td>55,633</td>
<td>64,871</td>
<td>81,439</td>
<td>154,719</td>
<td>282,471</td>
<td>401,206</td>
<td>635,768</td>
<td>1,037,501</td>
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<td>53,778</td>
<td>49,232</td>
<td>54,264</td>
<td>151,198</td>
<td>260,536</td>
<td>279,444</td>
<td>397,489</td>
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<td>13,967</td>
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<td>2.3</td>
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<td>43.6</td>
<td>59.9</td>
<td>50.6</td>
<td>69.8</td>
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<td>13,960</td>
<td>17,110</td>
<td>2,830</td>
<td>45,270</td>
<td>83,990</td>
<td>142,190</td>
<td>217,780</td>
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<td>539,190</td>
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<td>25,015</td>
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<td>1.1</td>
<td>5.6</td>
<td>7.1</td>
<td>13.9</td>
<td>53.6</td>
<td>65.4</td>
<td>58.4</td>
</tr>
<tr>
<td>706,000</td>
<td>826,000</td>
<td>1,633,000</td>
<td>1,825,000</td>
<td>3,768,000</td>
<td>4,875,000</td>
<td>6,948,000</td>
<td>11,000,000</td>
<td>16,500,000</td>
</tr>
<tr>
<td>667,069</td>
<td>627,047</td>
<td>963,963</td>
<td>1,650,676</td>
<td>2,676,096</td>
<td>41,054,544</td>
<td>6,519,650</td>
<td>8,931,015</td>
<td>13,317,084</td>
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<td>20,166</td>
<td>103,058</td>
<td>359,139</td>
<td>113,311</td>
<td>673,705</td>
<td>503,285</td>
<td>240,304</td>
<td>1,253,805</td>
<td>1,970,225</td>
</tr>
<tr>
<td>5.8</td>
<td>31.7</td>
<td>69.4</td>
<td>10.6</td>
<td>40.8</td>
<td>18.7</td>
<td>6.6</td>
<td>–87.7</td>
<td>23.9</td>
</tr>
</tbody>
</table>

14 It is likely that the increases in more recent years, especially in 1993, are related to increased deployment of security personnel to the southeast as part of the military campaign against Kurdish nationalists. See Ekinci 1994, p. 39.

15 Especially in textiles, large wage increases were granted with an implicit understanding between industry and the unions that the latter would not effectively resist layoffs.
Governance, Leadership, and Communication: Building Constituencies for Economic Reform

Figure 1
Producer Subsidies to Agriculture, 1979–93
Percent

Source: OECD 1994b.

A more general index of support is provided in figure 1. The index is the producer subsidy equivalent (PSE) for all the commodities in the sample (which includes all commodities that receive support in Turkey, with the exception of tobacco), and includes not only price support, but also estimates of subsidies provided through credit, fertilizers, seeds, and services (price support is always the dominant subsidy). The index suggests that resources de-
voted to agricultural producers were high—one-third of the production value—in 1979. Then, with the suspension of political competition and the fiscal retrenchment of the early 1980s, support declined considerably. It started to increase again in 1985, and reached around 40 percent in 1991–93.

The impact of this shift in policy can be traced through the movements in terms of trade between agriculture and industry. Following Boratav (1990), table 5 displays two estimates of terms of trade between agriculture and industry. Both indexes reflect a continuation of the deterioration of terms of trade against agriculture until 1988 and 1989, and improvements in 1990–91.

It is beyond the scope of this chapter to discuss agricultural policy in detail. It should be pointed out, however, that budgetary resources are spent not only as support to farmers, but also to maintain additional stakeholders in the government agencies taking part in the support mechanism. The case of Agricultural Sales Cooperative Unions (ASCUs) provides a good example. ASCUs are authorized to set prices for members’ commodities and implement support purchases on behalf of the state. In many cases they also have established capacity to undertake the initial processing of the produce, before it is sold to traders or exported. Even though this makes economic sense, some ASCUs have integrated forward to establish manufacturing plants that are uncompetitive and chronic loss-makers. The activities of the ASCUs are financed through credit from the state-owned Agricultural Bank. Accounting is very poor, and the bank cannot monitor how its advances are used—it cannot differentiate advances used for the implementation of agricultural policy from those used to finance the losses of the manufacturing plants. At the end of the financing season, only a fraction of the loan is repaid, and the remainder generates a claim for the bank on the Treasury in the form of “duty loss.” The Treasury ultimately finances not only subsidies allocated to farmers through support prices, but also the losses of the manufacturing plants. This form of rent dissipation increases the cost of agricultural policy substantially.

What about the fiscal impact of agricultural subsidies? An important part of support policies is implemented by specialized SEEs, and thus a significant part of the fiscal impact ultimately shows up in the borrowing requirements of the SEEs or in the transfers from the budget to the SEEs. A review of fiscal accounts is presented next.

**Impact of Distributional Pressures on Public Finances**

A brief perusal of the main components of public accounts in Turkey will help identify some of the dynamics behind the galloping deficits and locate the effects of increases in wages and agricultural subsidies. Table 6 records the distribution of total PSBR among the public accounts. The largest items are the central government and the SEEs. The borrowing requirements of the rest of the public sector, most notably the extra-budgetary funds (EBFs), local administrations, and Social Security, also increased, from a surplus of 1 percent of GNP in 1984 to a deficit of about 2 percent.

The next step is to examine the important accounts in more detail. Starting with the consolidated budget (see table 7), one can make several observations. The first is the big jump in personnel expenditures in 1989 and the sustained increase thereafter, which more than doubled these expenditures as a percentage of GNP between 1988 and 1993. Interest payments became the second major component of budgetary deficits, increasing, in a more or less sustained way, from
Table 6  
**Public Sector Borrowing Requirements (PSBR), 1984–94**  
Percent of GNP  

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Total public sector</td>
<td>5.3</td>
<td>3.5</td>
<td>3.6</td>
<td>6.1</td>
<td>4.8</td>
<td>5.4</td>
<td>7.6</td>
<td>10.3</td>
<td>10.6</td>
<td>11.7</td>
<td>8.2</td>
</tr>
<tr>
<td>Nonfinancial public sector</td>
<td>5.6</td>
<td>3.5</td>
<td>3.6</td>
<td>6.2</td>
<td>4.8</td>
<td>5.4</td>
<td>7.8</td>
<td>10.5</td>
<td>11.0</td>
<td>12.0</td>
<td>8.1</td>
</tr>
<tr>
<td>Consolidated budget</td>
<td>4.3</td>
<td>2.2</td>
<td>2.7</td>
<td>3.5</td>
<td>3.1</td>
<td>3.3</td>
<td>3.0</td>
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<td>4.3</td>
<td>6.7</td>
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</tr>
<tr>
<td>Nonfinancial SEEs</td>
<td>2.2</td>
<td>2.4</td>
<td>2.6</td>
<td>3.4</td>
<td>2.1</td>
<td>2.0</td>
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<td>3.3</td>
<td>3.8</td>
<td>3.5</td>
<td>2.7</td>
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<tr>
<td>Extra-budgetary funds</td>
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<td>-0.6</td>
<td>-1.6</td>
<td>-0.6</td>
<td>-0.5</td>
<td>0.3</td>
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<td>0.5</td>
<td>0.7</td>
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<tr>
<td>Local administrations</td>
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<td>0.4</td>
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<td>0.8</td>
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<tr>
<td>Financial SEEs</td>
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<td>0.0</td>
<td>-0.0</td>
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<td>-0.2</td>
<td>-0.5</td>
<td>-0.3</td>
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<tr>
<td>Revolving funds &amp; Social Security</td>
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<td>-0.4</td>
<td>-0.3</td>
<td>-0.6</td>
<td>-0.3</td>
<td>-0.4</td>
<td>0.2</td>
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<td>0.6</td>
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<td></td>
</tr>
</tbody>
</table>

Source: State Planning Organization.

Table 7  
**Consolidated Budget Revenues and Expenditure Components, 1985–94**  
Percent of GNP  

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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<tr>
<td>Revenues</td>
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<td>13.9</td>
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<td>13.6</td>
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<td>15.3</td>
<td>15.8</td>
<td>15.8</td>
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<tr>
<td>Expenditures</td>
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<td>17.4</td>
<td>16.6</td>
<td>16.9</td>
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<tr>
<td>Personnel</td>
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<td>3.</td>
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<td>6.7</td>
<td>7.8</td>
<td>8.5</td>
<td>8.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Other current</td>
<td>2.3</td>
<td>2.3</td>
<td>2.1</td>
<td>1.9</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Investment</td>
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<td>3.5</td>
<td>2.8</td>
<td>2.5</td>
<td>2.5</td>
<td>2.7</td>
<td>2.7</td>
<td>2.7</td>
<td>2.0</td>
</tr>
<tr>
<td>Interest payments</td>
<td>1.9</td>
<td>2.6</td>
<td>3.0</td>
<td>3.9</td>
<td>3.6</td>
<td>3.5</td>
<td>3.8</td>
<td>3.7</td>
<td>5.8</td>
<td>7.6</td>
</tr>
<tr>
<td>Foreign borrowing</td>
<td>0.7</td>
<td>1.3</td>
<td>1.3</td>
<td>1.4</td>
<td>1.4</td>
<td>1.1</td>
<td>1.1</td>
<td>0.9</td>
<td>1.2</td>
<td>1.7</td>
</tr>
<tr>
<td>Domestic borrowing</td>
<td>0.5</td>
<td>1.3</td>
<td>1.7</td>
<td>2.5</td>
<td>2.2</td>
<td>2.4</td>
<td>2.7</td>
<td>2.8</td>
<td>4.6</td>
<td>6.0</td>
</tr>
<tr>
<td>Transfers to SEEs</td>
<td>3.7</td>
<td>0.3</td>
<td>0.6</td>
<td>0.8</td>
<td>0.5</td>
<td>0.3</td>
<td>0.9</td>
<td>0.7</td>
<td>1.3</td>
<td>0.5</td>
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<tr>
<td>Other transfers</td>
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<td>3.9</td>
<td>4.2</td>
<td>3.4</td>
<td>3.0</td>
<td>2.5</td>
<td>2.6</td>
<td>2.7</td>
<td>4.3</td>
<td>4.0</td>
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<tr>
<td>Budget balance</td>
<td>-2.2</td>
<td>-2.7</td>
<td>-3.5</td>
<td>-3.0</td>
<td>-3.3</td>
<td>-3.0</td>
<td>-5.3</td>
<td>-4.3</td>
<td>-6.7</td>
<td>-3.7</td>
</tr>
</tbody>
</table>

Source: Treasury Monthly Indicators.

Table 8  
**Financing of the Consolidated Budget Deficits, 1985–94**  
Percent of GNP  

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Budget balance</td>
<td>-2.2</td>
<td>-2.7</td>
<td>-3.5</td>
<td>-3.0</td>
<td>-3.3</td>
<td>-3.0</td>
<td>-5.3</td>
<td>-4.3</td>
<td>-6.7</td>
<td>-3.7</td>
</tr>
<tr>
<td>Deferred &amp; advance payments</td>
<td>-0.3</td>
<td>-0.3</td>
<td>0.0</td>
<td>-0.0</td>
<td>-0.3</td>
<td>-0.1</td>
<td>0.0</td>
<td>-1.1</td>
<td>0.4</td>
<td>0.0</td>
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<tr>
<td>Cash balance</td>
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<td>-3.1</td>
<td>-3.4</td>
<td>-3.1</td>
<td>-3.5</td>
<td>-3.1</td>
<td>-5.3</td>
<td>-5.4</td>
<td>-6.3</td>
<td>-3.7</td>
</tr>
<tr>
<td>Financing</td>
<td>2.5</td>
<td>3.1</td>
<td>3.4</td>
<td>3.1</td>
<td>3.5</td>
<td>3.1</td>
<td>5.3</td>
<td>5.4</td>
<td>6.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Foreign borrowing</td>
<td>-0.6</td>
<td>-0.0</td>
<td>-0.4</td>
<td>0.1</td>
<td>-0.2</td>
<td>0.0</td>
<td>0.3</td>
<td>0.4</td>
<td>1.1</td>
<td>-1.8</td>
</tr>
<tr>
<td>Domestic borrowing</td>
<td>1.4</td>
<td>0.9</td>
<td>1.2</td>
<td>1.9</td>
<td>2.6</td>
<td>2.0</td>
<td>0.4</td>
<td>1.4</td>
<td>1.5</td>
<td>-1.8</td>
</tr>
<tr>
<td>Short-term borrowing</td>
<td>1.4</td>
<td>1.8</td>
<td>1.7</td>
<td>0.8</td>
<td>0.6</td>
<td>0.6</td>
<td>3.7</td>
<td>3.7</td>
<td>3.8</td>
<td>7.6</td>
</tr>
<tr>
<td>Central Bank</td>
<td>0.7</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.2</td>
<td>0.0</td>
<td>1.7</td>
<td>1.6</td>
<td>2.7</td>
<td>1.3</td>
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<tr>
<td>Other</td>
<td>0.4</td>
<td>0.4</td>
<td>0.9</td>
<td>0.2</td>
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<td>0.5</td>
<td>0.9</td>
<td>-0.1</td>
<td>-0.0</td>
<td>-0.3</td>
</tr>
</tbody>
</table>

Source: Treasury Monthly Indicators.
less than 2 percent of GNP in 1985 to close to 6 percent in 1993. Direct budgetary transfers to the SEE were not very high, which is quite misleading, as will be seen below.

The financing of the consolidated budget deficits is summarized in Table 8. Although at the end of 1970s recourse to Central Bank advances (at a low interest rate of 1 percent) was the main source of financing, during the 1980s the deficit was increasingly financed by selling government securities, most of which were held in the banking sector (see Table 8). The increasing share of short-term borrowing in the 1990s is indicative of the increasing credibility problems of fiscal policy, as well as attempts by the government to reduce the interest cost of borrowing.

The next step is to examine the factors behind SEE borrowing requirements. Most of the borrowing requirements of SEE are concentrated in seven enterprises. In 1990, these accounted for about 90 percent of total SEE borrowing requirements. By 1993, with the rapid rise of total SEE borrowing requirements, this share had decreased steadily to 65 percent. They collectively obtain about 80 percent of budgetary transfers, and account for about 50 percent of personnel expenditures of all SEE.

The reasons for financial deficits vary across SEE. Three of the seven are the government’s instruments in agricultural policy and carry out support purchases of sugar beet, wheat, and tobacco. Their financial deficits are thus closely related to their purchase of commodities at subsidized prices to sell at market prices. This category of the SEE borrowing requirement simply reflects agricultural subsidies. These three companies accounted for about 42-44 percent of total SEE borrowing requirements in the 1990s.

Among the remaining four in this group, two are industrial companies (a hard coal producer and an iron and steel producer). Their borrowing requirements originate from operational losses brought about by inappropriate technology, overemployment, and lack of investment to raise efficiency. One is a railroad company, and the last one is the electricity company, which is burdened by a heavy investment program. In these nonagricultural SEE, the main reasons for losses are rapid increases in wages and interest payments.

Table 9 demonstrates that for the SEE sector as a whole, the ratio of wage and salary expenditures to revenues increased from 15 percent in 1989 to 34 percent in 1993, and that of interest payments to revenues almost tripled, from 4 to 11 percent, in the same period.

It is well known that SEE suffer from overemployment. Nevertheless, it is generally believed that employment in SEE has not increased appreciably in the last decade. Depending on how one treats enterprises that are slated for privatization, the number of employees ranged between 550,000 and 650,000 in the mid-1980s (SPO 1993). The data also suggest some decline in the 1990s, possibly resulting from a combination of a ban on hiring and attrition. Based on a more consistent sample, Boratav and colleagues...

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16 These are the Sugar Company, Soil Products, and the State Monopoly.
(1993) reached a similar conclusion. Hence, the increase in the wage bill mentioned above is mainly the product of higher wages rather than increased employment.

Another source of revenue losses was created by the government’s policy of keeping the prices of producer SEE products low before elections. Although Decree Law 233 of 1984 stipulated that SEEs are to operate as commercial entities subject to the commercial code, and they are authorized to set their prices freely, in practice price increases are subject to ministerial review. The 1987 election is a case in point. The average wholesale price index of public sector production and agriculture was lagging behind its private counterpart by almost 20 percentage points over the first eleven months of 1987. After the November elections, prices jumped by 21 percent, but could not recover the lost ground; private sector prices increased by 7.2 percent after the elections (World Bank 1993). Expecting price increases after elections has become customary.

<table>
<thead>
<tr>
<th>Table 10</th>
<th>Public Revenues, 1984–94</th>
<th>Percent of GNP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total public</td>
<td>18.0</td>
<td>19.0</td>
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<tr>
<td>Direct taxes</td>
<td>5.7</td>
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<tr>
<td>Indirect taxes</td>
<td>5.2</td>
<td>7.1</td>
</tr>
<tr>
<td>Non-tax normal income</td>
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<tr>
<td>Factor income</td>
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<tr>
<td>Social funds</td>
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<td>-0.1</td>
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<tr>
<td>Consolidated budget</td>
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<td>10.5</td>
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<tr>
<td>Direct taxes</td>
<td>5.9</td>
<td>4.9</td>
</tr>
<tr>
<td>Indirect taxes</td>
<td>4.4</td>
<td>5.6</td>
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<tr>
<td>EBFs</td>
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<tr>
<td>Direct taxes</td>
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</tr>
<tr>
<td>Indirect taxes</td>
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<td>0.8</td>
</tr>
</tbody>
</table>

Source: State Planning Organization.

<table>
<thead>
<tr>
<th>Table 11</th>
<th>Tax Burden of Wage Earners</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wage earners</td>
<td>Share in national income (1)</td>
<td>Share in income tax (2)</td>
</tr>
<tr>
<td>1973</td>
<td>28.3</td>
<td>63.9</td>
</tr>
<tr>
<td>1987</td>
<td>17.1</td>
<td>38.2</td>
</tr>
<tr>
<td>1988</td>
<td>14.0</td>
<td>49.9</td>
</tr>
<tr>
<td>1989</td>
<td>15.0</td>
<td>54.9</td>
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</table>

<table>
<thead>
<tr>
<th>Non-wage-earners</th>
<th>Share in national income (3)</th>
<th>Share in income tax (4)</th>
<th>Tax burden (4)(3)</th>
</tr>
</thead>
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<tr>
<td>1973</td>
<td>71.7</td>
<td>36.1</td>
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<tr>
<td>1987</td>
<td>82.9</td>
<td>61.8</td>
<td>0.7</td>
</tr>
<tr>
<td>1988</td>
<td>86.0</td>
<td>50.1</td>
<td>0.6</td>
</tr>
<tr>
<td>1989</td>
<td>85.0</td>
<td>45.1</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: Oyan and Aydin 1991, p. 49.
Uneven Governance and Fiscal Failure: The Adjustment Experience in Turkey

in Turkey. This pattern was repeated before the elections in 1991.

A brief mention of the structure of government revenues is also necessary, if only to identify some of its political economy features. The tax base in Turkey is extremely narrow; agriculture is generally not taxed, and tax evasion among business establishments (except perhaps for the largest businesses) is widespread. Except for the introduction of a value added tax in 1985, the tax system has not undergone any significant reform. The share of indirect taxes has increased steadily (see table 10).

The tax system is heavily biased against wage earners. The share of wealth taxes is below one-quarter of 1 percent of GNP. The share of corporate taxes was as low as 2 percent of GNP in 1982, and it declined even further, to 1.6 percent, in 1991 (IMF, Government Financial Statistics). Tax brackets are not indexed to inflation, which leaves wage earners prey to bracket creep. The increase in the direct tax/GNP ratio in 1989–92 (table 10) essentially reflects the higher incomes of wage earners. Öyan and Aydin (1991) estimate that in 1989 the share of taxes collected from wage earners was more than three times their share in national income, whereas this ratio was about one-half for non-wage-earners (see table 11; also see discussion in Celasun 1989, 1990).

The corporate income tax, by contrast, was loaded with exemptions and deductions that substantially reduced the tax burden on corporations. Saygilioglu (1990) has estimated that these exemptions and deductions reduced the effective corporate income tax rate to 21 percent in 1988 from a nominal rate of 46 percent.

The Crisis and the Stabilization Program of 1994: Does History Repeat Itself?

The deterioration of fiscal accounts accelerated after the elections of 1991. The government was in a bind (see Ozatay 1995 for an account of the events that triggered the crisis of 1994). Financing the deficits by borrowing from the market was extremely costly; by 1993, interest payments had already become a major burden on the budget. Moreover, the government saw reducing interest rates as an important short-term policy objective (Ozatay 1995, p. 10). It tried to overcome the dilemma both by increasing the Treasury’s recourse to advances from the Central Bank and by attempting to administer the interest rate. A rapid increase in Central Bank advances occurred in the last quarter of 1993 and the first quarter of 1994. At the same time, its attempts to administer the interest rates in the Treasury auctions caused a rapid contraction in the bond market. A flight from the Turkish lira occurred. Foreign reserves of the Central Bank decreased from US$7.2 billion in November 1993 to US$3 billion in April 1995. Between January and April 1995 the currency depreciated by 150 percent.

On April 5, 1994, the government announced a new stabilization program (see OECD 1994a for a review of the program). The main elements of the package were a severe cut in expenditures, a once-and-for-all application of a net asset tax (and some other one-time taxes, such as a 10 percent surcharge on personal and corporate incomes), and rapid price increases for SEE products. There was a deep contraction of output in 1994, but the envisaged fiscal contraction did take place. There were strict cuts in current expenditures, both in personnel and other areas.

As can be seen in the final row of table 2, the brunt of the fiscal adjustment was again born by civil servants and public sector workers. In that sense, the fiscal contraction of 1995 is reminiscent of the one that took place in 1980–82. Its sustainability will be contingent on additional measures that address the structural problems that make public finances captive to distributive pressures. A number of such measures were included as government’s intent. Not much was done in 1995, however, except for the passage of a privatization law. That in itself was very important, but the passage of the law is still only...
a first step in an arduous process that is both politically and administratively complex. Moreover, the impact of privatization on the major loss-making SEEs is unlikely to be large; it is probable that it will not be possible to privatize some of the enterprises, such as the coal mines. In the case of agricultural SEEs, financial problems originate from the structure of agricultural support policy; the implications of privatization for these SEEs are not yet clear.

**Governance in the Economic Reform Period**

An important dimension of the government’s approach to governance was centralization of key decisionmaking processes and increasing the discretionary authority of the executive, especially the office of the prime minister. In a sense, centralization was seen as the solution to the governance problems that afflicted the country before the military takeover. On the one hand, it was seen as a means to circumvent “pathological bureaucratization”; on the other, it was viewed as a solution to stalemate in the Parliament.

Centralization was aimed at reducing the power of the traditional bureaucracy. The civil service was seen either as too slow, not dynamic, and unresponsive to people’s demands, or as ideologically too committed to state intervention, not market-oriented, and too caught up in its procedural maze. Ozal attempted to restructure or bypass the traditional bureaucracy. For example, the Ministry of Finance was left with the responsibility of revenue collection. Other fiscal tasks were transferred to an Undersecretariat for Treasury and Foreign Trade, which was linked to the prime minister’s office, and someone close to Ozal was put in charge (Heper 1990, p. 612). Autonomous groups were created in some units to carry out projects that were seen as important. In other cases (for example, in the state-owned banks, the Central Bank, and some SEEs), people outside the civil service were appointed to positions of authority.

These appointees were usually young, foreign-educated, and, most important, people that Ozal could trust. More generally, Ozal worked with a small set of advisers, and the influence of the rest of the cabinet on the policymaking process was reduced. A governmental decree passed in 1984 supported this arrangement by strengthening the prime minister in relation to individual ministers.

A closely related aspect of centralization was the attempt to bypass the Parliament. This effort was facilitated by the restructuring of the political system that was brought about by the Constitution of 1982, written under the military regime. In order to prevent the stalemates that characterized the political process in the late 1970s, framers of the Constitution wanted to empower the executive over the legislature. The Constitution enables the government to request authorization to issue decrees that have the force of law. Once published in the *Official Gazette*, the decrees must be referred to the GNA for approval. What this meant was that the executive could avoid the legislative process and the accompanying debate, and limit the legislators’ choice to whether or not to approve a policy already being implemented. In 1984 a law was passed that enabled the Council of Ministers to pass such decrees with the force of law (Heper 1989, p. 465).

Another instrument that the government used to circumvent legislative oversight was the establishment of extra-budgetary funds (EBFs). Al-

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17 Various aspects of the process of centralization are discussed in Heper 1989, 1990; Onis 1992; and Onis and Webb 1994.
18 The 1982 Constitution introduced some fundamental changes into the political process. For reviews see the papers in Ozbudun and others 1988; Ozbudun 1994; and Turan 1994. The discussion of decrees in the text draws on Kalaycioglu 1988.
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though EBFs existed in Turkey prior to the 1980s, their use in the public sphere to mobilize and allocate resources has greatly expanded during the economic reform period (see Arslan and Akkaya 1993; Oyan and Aydin 1991). The stated reason for the establishment of the funds was the need for flexibility in raising new and temporary revenues and the advantage of the ability to effect expenditures without having to go through the arduous procedures of budgetary approval and control. The EBFs accorded the ANAP governments—especially the prime minister—discretionary authority to allocate fiscal resources without the prior approval of the Parliament. As of 1992, out of a total of 104 funds, only three were audited by the High Court of Accounts (Sayistay), which audits public accounts as an agent of the Parliament. The rest of the funds were audited by a High Board of Supervision, which is affiliated with the Prime Ministry.19

The tendency to centralize decisionmaking authority and to bypass the traditional bureaucratic and political processes was coupled with a preference to appeal directly to the public. Although in the early 1980s the majority of the established media elite was opposed to economic reform, Ozal made effective use of the media, especially state-controlled television, to explain to the public his objectives in pursuing the reform program. He would present himself as a reformer; his discourse emphasized individual entrepreneurship and initiative, “free market economy,” international competitiveness, economic development, and the primacy of the individual in relation to the state. He argued that the state should not and could not act as a paternal state. In recessionary periods, he would respond to the private sector’s complaints and requests for assistance by inviting them to “sell their villas” to finance their companies. These themes were presented as essential components of a development strategy for Turkey’s leap into a new epoch (cag atlamak). In a regular television program he would talk about how state intervention in the past had violated the “laws of the market” and why the government’s reform program was “the only alternative.” Although even at that time it was possible to identify fundamental inconsistencies between his words and the deeds of the ANAP governments,20 he was successful, at least until the second half of the 1980s, in presenting himself as a leader with a new vision for the future of the country. The term “vision” became an important theme in public discourse.21

Ozal presented new parameters for the discourse on economic policy. At the same time, there was a concerted effort by the government and business to accelerate Turkey’s integration into Europe, and a formal application was filed in 1987 for full membership in the European Community (EC).22 It is difficult to assess the relative impacts

19 By 1992 the total expenditures of the funds reached about one-third of the expenditures of the consolidated budget. The funds are primarily financed by earmarked levies and income generated by their investments. Their objectives vary from providing investment and export incentives, financing public investment (especially in infrastructure), providing subsidized credit, and providing resources for social programs. Two of the funds, the Support and Price Stabilization Fund and the Development Support Fund, took part in the government’s agricultural support policy. Over time, it seems that even the government lost track of the activities of the funds. In 1988, as part of austerity measures, the EBFs were required to transfer up to 30 percent of revenues to the Treasury. In 1993 most EBFs were incorporated into the budget.

20 Many inconsistencies were emphasized in the press. For example, the centralization of the state and the legal framework that restricted trade union activity were inconsistent with his liberal and market-oriented discourse. Columnists would present examples of favorable treatment of businessmen associated with Ozal, contradicting his statements that the state should become less interventionist.

21 It may be pointed out that Ozal’s discourse was not limited to economic issues, although those were dominant in the earlier years. He progressively presented a disposition that was more liberal than was characteristic of the central right and left on issues such as religion, the military, and especially the Kurdish problem. Controversy about the extent of his liberalism continues today among the Turkish intelligentsia.

22 Integration into Europe is valued both because it is seen as a guaranty for the consolidation of democracy in Turkey, and because it would provide access for Turkish exports to the European market.
of Ozal's discourse and policies and the prospect of membership in the EC in the change in the business culture that came about in the 1980s, but that a change occurred is without doubt. At the minimum, it can be said that Ozal provided terms and even a language that popularized the idea of market orientation, and the reforms, and their relatively successful outcomes in the 1980s, provided the material basis for it. In any case, two important changes in the business culture seem to have occurred. First, entrepreneurial activity came to be more appreciated. The moral insecurity associated with profit-seeking, and a general suspicion, especially among the bureaucratic elite (see Bugra 1994), of business in general appear to have been greatly reduced in the 1980s. Market values such as efficiency gained salience. The second change has to do with the boundaries of what business legitimately could expect from the government. Demanding high protection from the state on the grounds of the promotion of national industry or the enhancement of national independence are no longer considered a legitimate business demand by the public, as it was in the 1960s and the 1970s. Exports, and ability to compete internationally, have become indicators of how "good" a businessman one is.\(^2\) This does not mean that some elements of business do not demand protection (or, for example, oppose integration with Europe), or even that they would fail to obtain it. The point is that such demands no longer can count on the automatic support of public opinion. This change in the business culture is likely to be a very important factor that will build irreversibility into at least some of the market-oriented reforms introduced throughout the 1980s, especially in the area of international trade. The salience of the protectionist import-substitution model has terminated.

There was a visible concordance between Ozal's emphasis on entrepreneurship and the tendency to increase discretionary authority to the detriment of—and even to circumvent or disregard—established rules and norms, especially as they related to political and administrative procedures. What differentiated ANAP was its emphasis on getting things done; if that required going around rules, so be it. Initially this was refreshing for a populace that suffered from "bureaucratic pathology" and political stalemate. In both a central government and local governments dominated by ANAP (most notably, in Istanbul), going around rules, or even engaging in alleged irregularities, was condoned by the general public if that was necessary to deliver services. This was seen as form of effective governance; its effectiveness made it legitimate. Moreover, it is clear that centralization enabled the government to push ahead with economic reform on a number of fronts in a relatively short period of time.

Some measures taken to facilitate the citizens' dealings with the bureaucracy also projected an antibureaucratic attitude. Procedures such as obtaining driver's licenses, identity cards, passports, and building permits were simplified. Similarly, it became easier to pay taxes, obtain foreign exchange for travel abroad, get a marriage license, or even apply to a state school (Heper 1989, p. 465). These measures affected the daily life of ordinary citizens and were extremely popular. In a similar vein, but perhaps of more economic significance, in order to expedite the granting of export incentives and reduce red tape, the disbursement of incentives was centralized in the Directorate of Incentives and Implementation (TUD) within the State Planning Organization. Previously, exporters had to deal with each agency that granted incentives separately.

In time, however, this style of governance was carried to extremes, and it became a weakness of the ANAP governments. Rules were changed arbitrarily, and governance started to look

\(^{23}\) Perhaps one of most illuminating examples occurred when one of the largest holding groups in Turkey attempted to oppose a partial liberalization of automotive imports—their opposition was largely condemned.
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personalized and arbitrary. The initial appeal of circumventing oppressive rules gave way to a concern about lawlessness or an absence of respect for the norms. What had been interpreted earlier as entrepreneurial initiative came to be seen as improper behavior, accountable to no one. In extreme cases, newspapers reported large numbers of alleged cases of irregularity in the disposition of contracts or allocation of export incentives. EBFs looked completely out of control, and they were seen as ANAP's instruments of pork barrel, and one with no accountability. More generally, concern arose about the absence of norms and moral values. As one sociologist put it, "liberalism is not an unconstrained [state of] freedom where anything goes. As liberalism develops, the need for ethical values increases" (Gole 1993, p. 16, author's translation). A general decay in codes of conduct, especially surrounding the state and political power and in areas where private citizens interact with the state, became prevalent. This was probably one of the reasons why ANAP started to lose its popularity toward the end of the 1980s.

To summarize, while extensive discretion and centralization of decisionmaking were instrumental in pushing reform and gaining popular support for it in the early 1980s, it created an atmosphere of lawlessness that eventually resulted in a decline in the popularity and political power of ANAP. The same factors had even more serious implications for interparty competition, and in consequence, on the fiscal policy that was conducted by the different governments. This problem is taken up next.

**Distributional Conflict and the Problem of Cooperation in Politics**

Failure in macroeconomic stabilization was shown in the preceding sections to result from rapid increases in wages and salaries, as well as agricultural subsidies. In the case of wages and salaries, it is interesting to note that while workers in the public sector could exert pressure in an organized manner through their unions, this was not the case for civil servants. Rather, it seems that an increase in the general public awareness about income loses incurred by civil servants throughout the adjustment period was sufficient to prompt the government to take corrective actions. It seems that in the case of civil servants, it was the government's concern about looking unfair that was important, rather than the effects of direct pressures or confrontation. In the case of agricultural subsidies, increases were closely associated with the return of political competition and the reemergence of the agricultural sector as an important block of votes.

In hindsight, one is not surprised that persistent worsening of income distribution proved unsustainable over time. No amount of "political will" could have resisted what looked like legitimate demands, especially at a time when the economy was growing. The important question is whether the crippling effect that improvements in wages, salaries, and agricultural incomes had on public finances could have been avoided. The answer is probably affirmative, but only if these improvements were undertaken along with other significant structural changes.

In the case of the civil servants, who are still grossly underpaid compared with workers in the private or public sector, this would have required civil service reform, including a significant retrenchment. There is overwhelming consensus in Turkey that there is severe overemployment in the civil service, and that, as in many other countries, at least in terms of financial considerations, a reduction in its size would free resources and allow for more reasonable pay schedules.

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24 In a much-quoted example, Otel is reported to have said that "no harm would be done by violating the constitution once" (Bugra 1994, p. 164).
In the case of nonagricultural SEEs, granting wage increases without major restructuring or privatization was bound to cause further deterioration in their financial positions. Major restructuring would have required de-linking the SEEs completely from the political process and preventing their use as instruments of patronage (through employment policy) or electoral politics (through pricing policy). It would have meant closing down enterprises that are not viable within a program that provides adequate compensation for workers who lose their jobs. In the case of SEEs that are used as instruments of agricultural policy, a major revamping of that policy would have been necessary, both to target the subsidies better to the poor farmers and to increase the efficiency of transfers, thereby reducing the amount of resources that would be necessary to support the targeted social group.\textsuperscript{25}

A final and important possible measure was to improve the system of taxation. A fundamental tax reform could have improved both equity and income distribution, decelerated the deterioration of the incomes of wage and salary earners in the early years of reform, and increased the fiscal resources of the state, enhancing its capacity to meet distributional challenges without crippling public finances. There was certainly ample room to increase tax revenues.

The difficulty was not that there were fundamental disagreements on what needed to be done, especially among the parties on the center-right. They did not have any deep ideological differences on the model of development—both conformed to market orientation. Moreover, it did not take much to see that this race to disburse the state’s resources would soon create an unsustainable situation. That this race could not be stopped identifies a major instance of the failure of governance capacity.

The fiscal problem, or the way in which state resources are used for political competition, can be usefully conceptualized as a problem of cooperation. When all contenders for political power behave in a predatory manner, and use, or promise to use, state resources to enhance their chances of public office, the outcome is ultimately severe fiscal deterioration of the kind Turkey experienced in the late 1980s and the 1990s. There is a cooperative outcome as well, where the contenders are able to commit themselves to refrain from behaving in a predatory manner, or refrain from the excesses of fiscal expansion. This way may avoid macroeconomic instability and crises, which hurt all contenders. Without commitment mechanisms, however, the cooperative outcome is unlikely to prevail, because if one party refrains from behaving predatorily, the other has incentives to predate. The governance problem in Turkey can be thought of as the absence of mechanisms that would support the cooperative outcomes and prevent predatory behavior.

As discussed in the second section of this chapter, The Turkish political system lacked norms and mechanisms that could support compromise and cooperation among political actors. In the fiscal area, the very availability of vast discretionary resources probably encouraged noncooperative outcomes. Perhaps more important, however, the use of fiscal resources has been deeply ingrained in the political culture, and it was very much the mechanism through which political participation and democracy have developed in Turkey. Predictably, there were no legal or procedural rules, such as limits on the accumulation of public debt, that could have restrained fiscal expansion. There were some limits on the extent to which the Central Bank could depend on Central Bank financing, but these were flexible; they actually became irrelevant because the fiscal expansion was primarily financed by government debt.

If absence of such norms was the “structural” governance problem, one can perhaps go a step  

\textsuperscript{25} Possible approaches to reform agricultural policy in Turkey are discussed in Ziraat Muhendisleri Odasi 1993 and OECD 1994b.
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Further and identify a leadership problem as well. If norms to constrain predatory behavior are absent in the Turkish political culture, could the political leaders of the last fifteen years have taken steps to support more cooperative behavior? Perhaps, but clearly this is not what happened.

ANAP’s centralized and discretionary approach to governance not only eventually undermined its own popularity with the public, but it also reduced its capacity to install interparty cooperation. During its rule, and with the prospect of intensifying political competition, ANAP was faced with a choice. Resolving the cooperation problem would have required soliciting basic agreements about the fiscal rules of the political game and/or implementing mechanisms to tie both its hands and those of its competitors. Given Özal’s rhetoric for reducing the role of the state, one would have expected steps in these directions. Interestingly, implementing the structural reforms mentioned above would have created mechanisms of commitment by fundamentally altering—and in some cases eliminating—the instruments that allow fiscal resources to be used for political competition. Instead of creating such mechanisms of commitment and cooperation, the ANAP governments increased their discretion over such resources and undermined any potential for cooperation.

As for the coalition that followed the rule of ANAP, in the noncooperative mode that characterized the elections environment, they came to power with a long list of liabilities. In an editorial entitled “Great Expectations in Ankara,” one journalist described the days following the elections in the following way (Ulagay 1994, p. 58, author’s translation):

People who have been far away from political power for ten plus years, now are flowing to Ankara expecting a lot from their parties that are partners in political power. . . . Along with their congratulations, they are bringing their demands. . . . A job for an acquaintance, support for an unfinished project, resources for such and such local government, demand for appointments in order to save such and such place from the influence of the sympathizers of the former government. Endless demands. . . .

Demirel himself, returning to power after eleven years, “spent about three months receiving delegates from his party’s organizations all over Turkey, giving speeches, listening to their demands, and making promises” (Gunes-Ayata 1994, p. 58).

One observes here the extreme sensitivity of the party organizations and leadership to constituency demands that was endemic to the polity before the military takeover. The collective action or public goods problem that characterized this sensitivity was discussed earlier in this chapter. The interesting aspect of the Turkish experience lies in the acceleration of fiscal deterioration after the 1991 elections. This demonstrates that the “expectations” and “promises” referred to in the quotes above are not empty plays to win elections; there are mechanisms in the political process that make these promises enforceable.

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26 Here I follow Frischtak (1995) in differentiating between aspects of governance that can be assessed by governing institutions, and those “intangible” and “less predictable” elements such as leadership.

27 There were a number of additional incidents that possibly increased the dose of confrontation between the ANAP government and the opposition. Among these were ANAP’s manipulation of electoral laws to increase its chances of success (which was interpreted as unilateral disregard for the rules of the game) and ANAP’s opposition to the lifting of the ban on former political leaders (Ozbudun 1994, p. 48).

28 In some incidents, the electoral campaign resembled a bidding war in an auction. One contestant was quoted as addressing tobacco growers: “whatever ANAP is paying for tobacco, we will pay five thousand liras more” (the Turkish daily, Hürriyet, June 2, 1994).
Concluding Remarks

There was an important deficiency in the governance capacity of the state that manifested itself during the political crisis of the late 1970s. That deficiency was related to the inability of the political process to encourage the main political competitors to cooperate, especially during periods of tension, to attend to basic issues of public policy. Political scientists have identified this deficiency as the absence or inadequacy of political institutions that encourage successful bargaining and compromise.

The suspension of political competition by the military takeover and the restricted competition that characterized the earlier periods of the ANAP governments reduced the importance of this aspect of capacity in the making of public policy. ANAP adopted a style of governance that was centralized and emphasized results rather than procedures. It sought support and legitimacy by appealing directly to the public, emphasizing results, while it bypassed the traditional channels of debate, negotiation, and, whenever possible, implementation of public policy. This enabled the ANAP governments to implement a wide range of economic reforms without much challenge.

One must also emphasize here the leadership of Ozal in articulating a new set of social objectives and values that emphasized market orientation, entrepreneurship, and internationalization. His contribution was not so much in building the consensus that eventually emerged, but rather in providing the symbols, the themes, and the language that helped people to construct a generally shared sense of the future. In hindsight, contradictions in words and deeds, and even among the words themselves, turned out to be of secondary importance in the consolidation of this new "vision."

It seems that there were two things missing in Ozal’s—and, for that matter, ANAP’s—discourse and practice. First, it did not project a sense of social compassion, a recognition that there were groups who did not participate in sharing the benefits of the new regime and a willingness to do something about it. The importance of this in decreasing the popularity of the ANAP manifested itself most clearly when public opinion warmly supported the quest of workers for higher wages in 1989. Second, ANAP’s centralized approach to governance eventually became a weakness in more than one respect. First, it underestimated that legitimacy ultimately required some accountability, which was lacking. Second, as a matter of pure political strategy and tactics, it underestimated the eventual challenge of political competition ANAP would have to face. Third, centralized decision-making, restricting delegation to a small circle of technicians, must have ultimately overwhelmed the ANAP government and reduced its ability to control and monitor, as exemplified by allegations of irregularity and corruption. All of these added to the decline in the political support ANAP could muster from the population.

At a more general level, when political competition resumed, ANAP’s style must have aggravated the governance problem identified above. Resumption of political competition challenged the capacity of the state and the political process to encourage cooperation where cooperation is the desirable—but not the likely—outcome. Regulating political competition so that it generates acceptable and sustainable policy outcomes, preventing it from being disruptive, and encouraging political actors to reach agreements requires commitment mechanisms and institutions that reduce discretion (see Shepsle 1992 and Moe 1990 on the problem of commitment in politics). This is particularly true in the area of fiscal policy, and especially in this area, the ANAP governments increased the discretionary power of the state, rather than reducing it. Not only did the ANAP governments not attempt to undertake structural
reforms that would have reduced such discretionary capacity, but they also used the traditional instruments of patronage, and actually created more instruments that could be used for that purpose. There may be two explanations. One could be that this was ANAP’s mistake, or short-sightedness; the second could be that ANAP’s declared intention to reduce the size of the state was not sincere. It is difficult to judge which explanation is correct. The point is that during the ANAP governments, not much was done to repair this governance deficiency.

There is an important lesson of macroeconomic policy to be gained from the Turkish experience: in environments where norms and mechanisms to resolve cooperation problems are weak, stabilization programs that affect fiscal retrenchment by suppressing distributional demands are likely to be successful in the short run. Once the problem is resolved and macroeconomic stability is established, however, at least as long as the political system is competitive, distributive demands, and with them the public good nature brought about by macroeconomic stability reemerge, leading to macroeconomic disequilibria. A more sustained solution to the problem of macroeconomic instability may require “structural” reforms that address the mechanisms for the management of distributational conflicts in the society. In the case of Turkey, this would entail major reforms of SEEs, agricultural support policy, and the civil service.

Turkey currently is in an interesting situation. The last decade and a half of reform has created a vibrant private sector, and a state that is lagging seriously behind. Having reformed the aspects of the economy that relate to the economic activities of the private sector, it seems that the majority of the remaining tasks have to do with reforming the public sector.

29 Waterbury (1992) argues that the purpose of ANAP’s involvement in patronage and clientelism was to secure enough votes for reelection. I do not challenge the presumption that this was an important motivation, but the argument is incomplete. A more complete argument would have to show that patronage was the best strategy for reelection. Given that ANAP’s competitors had stronger party organizations and better links with rural local constituencies, it is unclear that this was the best strategy.

30 One should add that the emergence of major fiscal crises may in many cases reflect governance failures.
Appendix

Chronology of Turkish Politics in the 1980s

September 12, 1980  The military coup.

November 1982  National referendum accepting the Constitution and Evren's presidency for the next seven years.

Spring 1983  New electoral law on political parties; 15 new parties formed. Demirel, Ecevit, and another 700 politicians were banned from politics.

November 1983  General elections. ANAP, under the leadership of Ozal, wins majority. Ozal becomes prime minister.

March 1984  Local elections won by ANAP.

September 6, 1987  Referendum with which Demirel, Ecevit, and 100 other politicians were returned the right to political activity with a small majority of 100,000.

November 29, 1987  Second general elections. ANAP gets 63 percent of seats with 36.2 percent of the votes. Ozal remains as prime minister.

March 26, 1989  Municipal elections: ANAP, 22 percent; SDP, 28 percent; DYP, 26 percent of vote; big loss for ANAP.

April-May 1989  Labor unrest. May Day rallies for the first time since the coup.

November 1989  Ozal becomes the president through parliamentary vote.

January 3, 1991  One-day general strike organized by Turk-Is, which was spearheaded by 50,000 miners in Zonguldak.

October 20, 1991  General elections. DYP won the elections and ANAP came second. Coalition formed between DYP and SHP.
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State Capture and Fiscal Adjustment in Brazil

Leila Frischtak

Brazil has a history of protracted, uneven, and insufficient economic reform efforts. In the 1980s, governance capacity also deteriorated, leaving the state substantially depleted of control over the instruments of economic policy. This chapter argues that the short supply of capacity was the primary reason for the prolonged failure to promote a concerted reform program that could both reverse the increasingly unstable macroeconomic situation and introduce, in a consistent and sustainable way, the structural changes necessary for the resumption of economic growth and development.

The analysis below focuses mainly on the period of 1980–93, although it also briefly addresses the country’s more positive political and economic developments since the beginning of the 1994 stabilization plan. Even before this plan scored its successes in halting the spiraling and resilient inflation rates that had become a perverse trademark of the Brazilian economy, however, the early 1990s had already witnessed a gradual turnaround of the economy. The economy started its recovery before—and to a certain extent, in spite of—the state.

The second part of the chapter characterizes the performance of the Brazilian economy since the 1980s. It suggests that the apparent post-1991 decoupling of the economy at the microeconomic and macroeconomic levels possibly indicates that the productive sector of the economy was finally “weaning” itself from the state. It also briefly characterizes the Real stabilization program, its achievements and remaining challenges. The third part of the chapter discusses the fiscal problem, proposing that the rigidity of the federal budget, in earmarked transfers and other noncompressible expenditures, could be associated with an increased penetration of the state by interest groups, and the state’s decreased capacity to exert control over its own resources. The fourth section addresses the shortage of capacity of the Brazilian state and the impact of the transition to democracy, in the context of economic crisis, on the further weakening of the country’s political institutions. Finally, a concluding section explores the possible connections between visions and attempts to overcome situations of state capture. The argument underscores the importance of effective political communication in sustaining the course of economic reform.

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Post-1980s Economic Performance

A Decade of Postponed Adjustment

For one hundred years, Brazil had sustained an average annual economic growth rate of 6 percent, placing its economy as the eighth largest in the world by 1979. The scope of Brazilian state intervention had grown alongside its economy. In 1979, the share of the state sector in fixed capital formation reached 45 percent, and by the early 1980s there were 475 state enterprises and 75 subsidiaries in operation. In the 1980s, however, Brazil sharply reversed its long record of impressive economic performance. Underlying the prolonged stagnation that ensued was a lasting and deep-rooted inability to generate the conditions of fiscal and monetary stability and to effect a timely transition from an inward-looking, debt-financed, and state-directed industrialization strategy toward a more open, competitive, market-driven economy.

Few accounts of the Brazilian economic performance in the past decade can avoid the comparison to the country’s previous buoyant economic history. Most Brazilians never quite reconciled themselves to the reality of a stagnant or slow-growing economy. When contingencies result in successful and lasting patterns, they can easily be misinterpreted, as if there were some inherent inexorability in their endless repetition. Such illusions most likely played a part in preventing the country’s timely realization of the need for change.

Nevertheless, it would surely be a mistake to rely solely on the hold of past experience and short-sighted policymakers to explain a decade-long failure to alter seriously adverse economic conditions. Indeed, over a span of time in which the world economy suffered the effects of two major wars, a great depression, and many substantive transformations, Brazil’s past experience of sustained growth had demonstrated its remarkable capacity to adapt and respond to emerging external constraints and opportunities. Yet in the 1980s this capacity seemed to have all but vanished. The examination of possible causes for the persistent inability in altering the course and results of economic policy warrants, first, a snapshot review of the Brazilian economy in the “lost decade.”

The 1979 oil price shock and the onset of the debt crisis resulted in a sudden reversal in net resource transfer of considerable magnitude (from approximately +5 percent to −5 percent of GDP between the 1970s and the early 1980s), placing severe constraints on the financing of the public sector. There followed a series of attempts to solve the deteriorating macroeconomic imbalances. These attempts, most often in the shape of the stabilization plans that succeeded each other well into the 1990s, did not elicit outright opposition from society or the political class; nevertheless, they all proved to be either insufficient initiatives or sound failures. Although they varied considerably in their approaches, none of them managed to reverse, and instead accentuated, the primary feeding sources of disequilibrium—the growing lack of control on the public sector accounts and an accommodating monetary policy (the Appendix to this chapter presents a chronology of the adjustment initiatives and stabilization plans of the post-1980 period, identifying schematically their general orientation and impact on inflation growth rates).

Repeated policy shocks and pervasive macroeconomic instability rendered the economic environment particularly volatile throughout the 1980s (table 1). As inflation accelerated, the economy demonetized. The share of M1 shrank from 9.3 percent to 1.9 percent of GDP, making monetary policy mechanisms increasingly ineffective in controlling infla-
around 25 percent of GDP in 1970–83, and with the subsequent acceleration of inflation they shrank to an average of 22.6 percent in 1984–89 under the impact of the Olivera-Tanzi effect.

Expenditures, however, were pressured upward, in large measure by external and domestic debt service. The latter peaked in 1989, prior to the Collor Plan’s freezing of financial assets and the compression of interest rates on government bonds. After a short-lived, post-1982 attempt to lower the mass of wages and benefits paid to government workers, personnel expenditures also crept upward. Similarly, Social Security transfers proved inelastic, and have hovered around 7.5–8.5 percent of GDP for the past two decades. Thus, with the limited exception of fiscal subsides, all expenditure items seemed to be either noncompressible or outright expansionary.

Meanwhile, no serious effort was made to change the inward-looking orientation of the economy until as late as 1988, when the first comprehensive tariff reform took place, scheduling the gradual removal of nontariff barriers and the reduction in tariff levels and their degree of dispersion. By the middle of the decade protection against most manufactured imports was high, and expanding. In a cross-country comparison using international trade/GDP ratios as indicators of the degree of integration in world markets, table 3 shows Brazil trailing only India in the degree of closedness of its economy.

The absence of a long-term orientation to inform trade policy was conspicuous. The import protection of the 1970s was a constitutive element of a strategy to “deepen” the import substitution process, which also involved heavy public investment in infrastructure and the production of intermediates, as well as export incentives to compensate for the anti-export bias. In the 1980s,

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Table 1
Macroeconomic Indicators

<table>
<thead>
<tr>
<th></th>
<th>Inflation rate (percent of GDP)</th>
<th>M1 average growth</th>
<th>Investment/GDP ratio</th>
<th>Average annual growth GDP</th>
<th>Industry</th>
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<td>1975</td>
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<td>25.8</td>
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<td>1980</td>
<td>110.2</td>
<td>9.3</td>
<td>22.8</td>
<td>6.8</td>
<td>9.1</td>
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<td>1981</td>
<td>95.2</td>
<td>7.7</td>
<td>20.9</td>
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<tr>
<td>1982</td>
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<td>6.5</td>
<td>19.4</td>
<td>0.5</td>
<td>-0.2</td>
</tr>
<tr>
<td>1983</td>
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<td>5.1</td>
<td>16.8</td>
<td>-3.5</td>
<td>-5.8</td>
</tr>
<tr>
<td>1984</td>
<td>223.8</td>
<td>3.6</td>
<td>16.2</td>
<td>5.3</td>
<td>6.2</td>
</tr>
<tr>
<td>1985</td>
<td>235.1</td>
<td>3.5</td>
<td>16.3</td>
<td>7.9</td>
<td>8.3</td>
</tr>
<tr>
<td>1986</td>
<td>65.0</td>
<td>7.7</td>
<td>18.7</td>
<td>7.6</td>
<td>11.3</td>
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<td>1987</td>
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<td>17.8</td>
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<td>17.0</td>
<td>-0.1</td>
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<td>1.1</td>
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<td>1992</td>
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<td>14.5</td>
<td>-0.9</td>
<td>-5.0</td>
</tr>
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</table>

n.a. Not available.

a. General Price Index—Conceito de Disponibilidade Interna (Fundação Getúlio Vargas).
b. Real Manufacturing Product.

Table 2
Consolidated Government Current Accounts and Capital Formation as a Proportion of GDP

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>Other current net revenues</td>
<td>1.10</td>
<td>-0.76</td>
<td>-0.96</td>
<td>-1.08</td>
<td>-1.29</td>
<td>-1.56</td>
<td>-0.75</td>
<td>-0.85</td>
<td>-2.39</td>
<td>1.02</td>
<td>2.72</td>
<td>4.14</td>
<td>3.54</td>
</tr>
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<td></td>
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<td></td>
<td></td>
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</tr>
<tr>
<td>Wages &amp; benefits</td>
<td>8.29</td>
<td>7.46</td>
<td>6.27</td>
<td>6.45</td>
<td>7.10</td>
<td>6.71</td>
<td>5.79</td>
<td>6.77</td>
<td>7.35</td>
<td>7.75</td>
<td>7.89</td>
<td>9.68</td>
<td>10.37</td>
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<tr>
<td>Goods &amp; services</td>
<td>3.03</td>
<td>3.18</td>
<td>2.87</td>
<td>2.86</td>
<td>2.98</td>
<td>3.10</td>
<td>2.70</td>
<td>2.86</td>
<td>3.43</td>
<td>4.38</td>
<td>4.66</td>
<td>4.58</td>
<td>5.09</td>
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<tr>
<td>Transfers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Social Security</td>
<td>8.21</td>
<td>7.02</td>
<td>7.72</td>
<td>8.22</td>
<td>8.64</td>
<td>8.49</td>
<td>7.96</td>
<td>7.06</td>
<td>7.88</td>
<td>7.52</td>
<td>7.15</td>
<td>7.47</td>
<td>8.19</td>
</tr>
<tr>
<td>Debt service</td>
<td>0.65</td>
<td>0.44</td>
<td>0.76</td>
<td>1.08</td>
<td>1.13</td>
<td>1.64</td>
<td>2.50</td>
<td>3.26</td>
<td>3.52</td>
<td>3.13</td>
<td>3.11</td>
<td>6.03</td>
<td>1.88</td>
</tr>
<tr>
<td>Subsidies</td>
<td>0.77</td>
<td>2.81</td>
<td>3.69</td>
<td>2.68</td>
<td>2.50</td>
<td>2.68</td>
<td>1.63</td>
<td>1.54</td>
<td>1.38</td>
<td>1.58</td>
<td>1.22</td>
<td>1.92</td>
<td>1.70</td>
</tr>
<tr>
<td>Savings</td>
<td>6.13</td>
<td>4.67</td>
<td>2.26</td>
<td>2.27</td>
<td>1.82</td>
<td>1.24</td>
<td>1.05</td>
<td>-0.37</td>
<td>-1.45</td>
<td>-0.07</td>
<td>0.49</td>
<td>-3.72</td>
<td>3.42</td>
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<tr>
<td>Gross capital formation</td>
<td>4.42</td>
<td>4.12</td>
<td>2.35</td>
<td>2.59</td>
<td>2.37</td>
<td>1.85</td>
<td>1.95</td>
<td>2.26</td>
<td>2.99</td>
<td>3.14</td>
<td>3.16</td>
<td>2.92</td>
<td>3.46</td>
</tr>
<tr>
<td>Balance</td>
<td>1.71</td>
<td>0.54</td>
<td>-0.09</td>
<td>-0.32</td>
<td>-0.55</td>
<td>-0.61</td>
<td>-0.90</td>
<td>-2.63</td>
<td>-4.44</td>
<td>-3.21</td>
<td>-2.67</td>
<td>-6.64</td>
<td>-0.04</td>
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</table>

Source: IPEA 1989; IPEA-DIPES/GAC.

Table 3
Trade Indicators, Selected Economies (Average, 1980–1990)

<table>
<thead>
<tr>
<th>Economy</th>
<th>X/GDP</th>
<th>M/GDP</th>
<th>(X+M)/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>170.13</td>
<td>171.76</td>
<td>341.88</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>116.16</td>
<td>108.87</td>
<td>220.03</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>35.93</td>
<td>33.81</td>
<td>70.21</td>
</tr>
<tr>
<td>Chile</td>
<td>31.27</td>
<td>31.89</td>
<td>63.16</td>
</tr>
<tr>
<td>New Zealand</td>
<td>26.68</td>
<td>25.69</td>
<td>52.37</td>
</tr>
<tr>
<td>Venezuela</td>
<td>22.62</td>
<td>22.01</td>
<td>44.62</td>
</tr>
<tr>
<td>Uruguay</td>
<td>22.89</td>
<td>18.54</td>
<td>41.43</td>
</tr>
<tr>
<td>Turkey</td>
<td>17.54</td>
<td>19.17</td>
<td>36.70</td>
</tr>
<tr>
<td>Mexico</td>
<td>17.26</td>
<td>16.92</td>
<td>34.19</td>
</tr>
<tr>
<td>Australia</td>
<td>15.58</td>
<td>18.27</td>
<td>33.85</td>
</tr>
<tr>
<td>Colombia</td>
<td>15.22</td>
<td>14.28</td>
<td>29.50</td>
</tr>
<tr>
<td>Argentina</td>
<td>8.85</td>
<td>7.22</td>
<td>16.07</td>
</tr>
<tr>
<td>Brazil</td>
<td>9.13</td>
<td>6.85</td>
<td>15.98</td>
</tr>
<tr>
<td>India</td>
<td>6.37</td>
<td>8.89</td>
<td>15.26</td>
</tr>
</tbody>
</table>

Note: X represents exports; M, imports.

Table 4
Brazil, Imports and Exports

<table>
<thead>
<tr>
<th></th>
<th>Exports</th>
<th>Imports</th>
<th>Trade balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>2.739</td>
<td>-2.507</td>
<td>.232</td>
</tr>
<tr>
<td>1975</td>
<td>8.670</td>
<td>-12.210</td>
<td>-3.540</td>
</tr>
<tr>
<td>1981</td>
<td>23.293</td>
<td>-22.091</td>
<td>1.202</td>
</tr>
<tr>
<td>1982</td>
<td>20.175</td>
<td>-19.396</td>
<td>.779</td>
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<tr>
<td>1984</td>
<td>27.005</td>
<td>-13.916</td>
<td>13.089</td>
</tr>
<tr>
<td>1986</td>
<td>22.349</td>
<td>-14.044</td>
<td>8.305</td>
</tr>
<tr>
<td>1988</td>
<td>33.786</td>
<td>-14.605</td>
<td>19.181</td>
</tr>
<tr>
<td>1989</td>
<td>34.421</td>
<td>-18.293</td>
<td>16.128</td>
</tr>
<tr>
<td>1990</td>
<td>31.390</td>
<td>-20.363</td>
<td>11.027</td>
</tr>
</tbody>
</table>

export subsidies were progressively removed, partly as a result of mounting pressure in Brazil's main export markets, and partly because of growing fiscal constraints. The resulting trade regime left the burden of generating the trade surpluses necessary to meet foreign debt service on import compression. The relatively slow growth of exports in the period is shown in Table 4. Trade volume, which had grown approximately by a factor of eight in the 1970–80 period (from US$5.246 billion to US$43.870 billion), grew less than 25 percent in the next decade (reaching US$52.672 billion by 1990).

There may be several complementary reasons underlying Brazil's delayed reaction to the rapidly changing international environment. As mentioned earlier, overreliance on the successful patterns of past experience may have contributed to the prevention of opportune realization of the need for change. In addition, attachment to a political culture of autarchic orientation, which associated self-sufficient industrial capacity with values of national sovereignty, outlasted the economic reversal of the early 1980s. Although this culture rarely translated exactly into practical policy goals, its importance in conspiring against automatic popular support for an outward reorientation of the economy should not be underestimated. It is also clear that both this culture and the practice of protecting the domestic market against imports were supported by powerful interest groups that, with privileged access to policymakers and the media, were able to convincingly articulate resistance to change in terms of the national interest (even though the actual power of these groups in blocking changes in trade and industrial policies would eventually prove rather ineffective). In addition, there was still a lack of strong constituencies for any structural reforms associated—both in normative and practical terms—with a reduction of the attributions of the state.

Finally, and probably a more decisive consideration than all other factors, the short-term macroeconomic management requirements of a high-inflation, low-growth environment overshadowed and subjugated all other longer-run policy concerns. Indeed, as the difficulties of this management compounded with every successive policy shock failure, there was increasingly less room for considerations of longer-term development strategies, and least of all for a concerted movement to craft support for a radical change in the prevailing strategy.

Nevertheless, it is precisely this prolonged failure to halt macroeconomic instability that begs a satisfactory account. Stabilization was not in itself contingent on a change of culture and perceptions of the past, and it is intrinsically pertinent to all economies, regardless of the development strategies in place. Governmental initiatives to promote stabilization could—and did—count on the immediate support of the majority of the population, who bore the brunt of the costs of spiraling inflation. Finally, there was never any shortage of economic expertise in the country, and the government could always take its pick in recruiting bureaucrats able to make competent policy decisions.

In contrast to the more identifiable factors behind slow structural reform, there is thus a meager repertoire of explanations for the country’s persistent difficulties in effectively addressing the root causes of macroeconomic disequilibrium. The sheer magnitude of this disequilibrium, and its ever-increasing cost in income foregone, would seem to have prompted more forceful and convincing policy reactions, were it not for a state already grown too weak to withstand their political risk. A strong and sustainable governmental stance in support of fiscal and monetary discipline required the capacity to disrupt the game of power politics that consumed a mounting portion of state resources. Such a stance was also inimical to the transition to democracy unfolding in the decade; the reemergence of party politics made the course of economic austerity powerfully unattractive, and prompted a consideration of the costs of an adjustment-driven recession measured by the ex-
pected lost votes, if not by the danger of major setbacks in the very transition process itself.

Hence, if there was a political stance attached to postponing adjustment, it was surely related to the generalized defensive attitude underlying Brazil’s economic performance in the 1980s; policy formulation, deprived of an overall sense of direction, tended to follow a short-term survival logic. While in the 1970s the state could be characterized by its role in promoting and managing development, in the 1980s it was left only its gigantic proportions; the state became “the caricature of its own previous model” (J. Velloso 1993, p. 105).

Dissonance in Economic Response: Macroeconomic Instability and Fledgling Microeconomic Resurgence

Prolonged crises eventually generate natural constituencies for change. Although slow and reluctant in the making, by the early 1990s a virtual consensus had emerged among Brazilian analysts; business and professional groups; and in many, but by no means all, relevant policymaking circles that the past pattern of development and its form of financing had been irreversibly exhausted (Bonelli and Markwald 1994). The long-lasting romance with autarchy had gone sour, or bankrupt, and the view that the country had to rethink its future in terms of a more aggressive competitive position in the world economy, as well as to conceive a new role for the state, commanded growing support.

In consonance with this shift of collective perception on the nature of the economic crisis, the early 1990s presented a considerably less monotonic picture of failure. Indeed, there was a decisive change in policy orientation, with the first two governments of the decade demonstrating a much stronger commitment to resolve the macro-economic situation and promote structural reform. While the difficulties in improving monetary and fiscal conditions would persist, the record of policy initiatives and results proved far from uniformly poor.

The first undisputable achievements occurred in trade liberalization. In addition to a significant reduction in tariff levels and their degree of dispersion (see table 5), several nontariff barriers, critical elements of the old import substitution model, were phased out, including the Law of Similars, which banned, for all practical purposes, the import of products manufactured in Brazil; the “nationalization index” requirements, which forced firms to either vertically integrate to such a degree that they became economically hobbled, or to procure parts and components domestically, even if that meant a significant loss in international competitiveness; and the process of project approvals essential to the tax concessions and subsidized finance that benefited firms able to help in the physical balance of the supply-demand equation and fill an identified product gap within a strategy of across-the-board import substitution.

By 1991 the system of price controls in the private sector had been largely abolished; essentially only public sector prices remained subject to control. Extensive deregulation also took place; entry barriers were greatly reduced or suspended, fiscal incentives erased, and credit incentives compressed significantly (World Bank 1993).

Partly as a response to these initiatives, and partly as a reaction to the recessionary economic environment of the 1980s, productivity gains in most sectors of the economy were sizable, particularly in the industrial sector. The hourly productivity of industry, for instance, grew from an index of 75.2 in February 1989 to 125.4 by November 1993, a jump of some 65 percent in less than five years (table 6), while prices

---

3 President Collor, elected on an anticorruption, proreform platform, took office in January 1991. Less than two years later, he was impeached by Congress in the midst of an outbreak of corruption scandals involving the executive. The presidency was handed down to Vice-President Itamar Franco, who remained president until new elections brought President Cardoso to power in 1995.
of consumer durables fell by 50 percent in the 1990–93 period.

Unemployment, which had increased consistently after 1989, reaching a record high in 1992, started a clear descent, underscoring the massive restructuring that took place in the aftermath of the 1990 trade reform and the recovery trend from 1993 onward (table 7).

The year of 1993 offered particularly impressive results. Productivity surged, and so did real wages. Overall hourly labor productivity gains from January through December of that year reached 18.8 percent, led by the most technology-intensive segments: electronic and communications equipment (39.9 percent); transport material (39.1 percent); and nonelectric machinery and equipment (20.6 percent). While unit labor costs fell by 6 percent, the real hourly wage rates increased by 10.9 percent. Additional indicators of a fledgling “productive revolution” in Brazil were manifest in the efforts of Brazilian firms in total quality management. By June 1994, the number of firms certified to conform to the ISO-9000 standards had reached 354, with the

---

Table 5
**Evolution of the Tariff Structure**

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Average</td>
<td>51</td>
<td>41</td>
<td>35</td>
<td>32.2</td>
<td>25.3</td>
<td>21.2</td>
<td>17.1</td>
<td>14.2</td>
</tr>
<tr>
<td>Mode</td>
<td>30</td>
<td>40</td>
<td>40</td>
<td>40</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>26</td>
<td>17</td>
<td>20</td>
<td>19.6</td>
<td>17.4</td>
<td>14.2</td>
<td>10.7</td>
<td>7.9</td>
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<tr>
<td>Amplitude</td>
<td>0–105</td>
<td>0–85</td>
<td>0–85</td>
<td>0–85</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>0–35</td>
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n.a. Not available.


Table 6
**Industrial Productivity Growth**

<table>
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</thead>
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<tr>
<td>Hourly productivity</td>
<td>75.2</td>
<td>81.2</td>
<td>78.1</td>
<td>87.8</td>
<td>100.0</td>
<td>125.4</td>
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<tr>
<td>Growth rate</td>
<td>—</td>
<td>8.0</td>
<td>(3.8)</td>
<td>12.4</td>
<td>13.9</td>
<td>25.4</td>
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</table>


Table 7
**Indicators of Open Unemployment**

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<th></th>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Six major metropolitan regionsa</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>4.10</td>
<td>3.70</td>
<td>4.00</td>
<td>3.7</td>
<td>4.30</td>
<td>5.10</td>
<td>5.70b</td>
<td>5.50</td>
<td>5.05c</td>
<td></td>
</tr>
<tr>
<td>Metropolitan region of São Paulo 6</td>
<td>6.70</td>
<td>6.80</td>
<td>5.02</td>
<td>3.34</td>
<td>3.76</td>
<td>4.02</td>
<td>3.44</td>
<td>4.55</td>
<td>5.52</td>
<td>6.51</td>
<td>5.81</td>
<td>5.88</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>7.38</td>
<td>6.58</td>
<td>5.11</td>
<td>3.42</td>
<td>4.78</td>
<td>5.00</td>
<td>4.05</td>
<td>5.67</td>
<td>6.94</td>
<td>8.41</td>
<td>7.12</td>
<td>6.67</td>
<td></td>
</tr>
</tbody>
</table>

b. Average for January–May period.
c. September only.
d. Annual average.

Source: IBGE, Pesquisa Mensal de Emprego.
expectation that this total would reach 850 by 1996.4

Thus, even while the macroeconomic picture remained dismal—inflation consistently soared, reaching almost 50 percent monthly by June 1994—extensive adjustment seemed to be taking place at the microeconomic level across the economy. This was a different story from that of the lost decade, and it contributed a different sequence from that advocated by most adjustment analysts, according to whom stabilization should precede structural reforms. This story pointed to the existence of a dynamic economy, with no shortage of resources and entrepreneurial agents to react to incentives. But how could one account for this incongruent performance of the economy at the macroeconomic and microeconomic levels?

The most noticeable efficiency gains seem to have been realized in areas of economic activity where the appropriate incentive structure either could be generated mostly through deregulation (primarily price decontrols, relaxing of import restraints and reduction of protection levels, and removal of subsidies) or did not require complex centralized governmental coordination (such as programs to disseminate information and technology that could be delegated to individual agencies). In other words, positive developments took place, both in policy and output, where the demand for state capacity was relatively low.

While it is naturally intuitive that macroeconomic stability should be heavily dependent on governmental capacity, it is pertinent to note the interesting break with the past, as the real side of the economy started its recovery without—or in spite of—the state. Indeed, the prior resurgence of economic dynamism at the microeconomic level suggests a rather novel decoupling in the Brazilian context: the economy’s productive sector, tacitly associated by most Brazilians for a long time in both performance and growth with state intervention, was in the process of adjusting itself out of the state.

It could be argued that whether or not these developments would prove enduring was still contingent on a significant reduction of the uncertainty that constrained investment and output growth. High and volatile inflation also posed widespread efficiency losses, not necessarily or entirely offset by the opportunities to appropriate inflationary rents. By mid-1994 there remained the pressing challenge of overcoming the problems of macroeconomic stability. The next pages briefly address the policy record since then.

The Battle Over Inflation and the Continuing Challenge of Macroeconomic Reform

One of the most obvious and perverse characteristics of prolonged inflation is its self-generating, or inertial, element, as economic agents attempt to defend themselves from the threat of future losses in an anticipatory manner. The history of successive shocks in Brazil had aggravated this tendency, leading those who were in price-making positions to repeatedly practice preemptive increases, and workers to organize politically to guarantee their share of income (Modiano 1990). Thus, in the absence of price and wage controls, any attempt to promote macroeconomic stabilization in a high-inflation environment depended largely on the willing and concerted cooperation of economic agents, and therefore on the prior reduction of uncertainty. Part of the policy challenge thus lay in fully convincing major players that price controls or major disruptions in contracts, particularly those governing financial transactions, would not take place.

In late 1993, under the leadership of Finance Minister Cardoso, the government launched yet

4 It is noteworthy that in the same period there were 1,600 certified firms in the United States; 1,300 in France; 1,000 in Canada; 800 in Italy; 120 in Austria; and a mere 6 in Argentina, despite its successful efforts in achieving macroeconomic stability (Brazil, Ministry of Industry, Commerce and Tourism 1994).
another comprehensive macroeconomic reform program. The Real Plan, as it was called, was conceived as a three-pronged initiative: in the first phase, it was intended to address fiscal reform, and in two subsequent stages, to deal with monetary reform. The latter initially called for the temporary establishment of a new, daily adjusted inflation index. It was expected that all market prices would voluntarily adhere to this index, which would be followed by the institution of a new currency and the legal suspension—for one year—of indexation in all contracts, in both the public and private sectors.

The fiscal reform initiative of 1993–94, which will be addressed later in this chapter, met with strong opposition in Congress, and was otherwise significantly compromised by the legal obstacles a previous, aborted attempt to change the Constitution had failed to remove. Nevertheless, even in the absence of the necessary comprehensive fiscal reform, a number of fiscal preadjustment measures were taken. The local states’ debt with the federal government was renegotiated so that payments could be resumed, a much stricter cash-cage control on governmental expenditures was imposed, the efficiency of tax collection was noticeably improved, and public tariffs, particularly those of state enterprises, were adjusted. It was in monetary reform, however, that the Real Plan achieved its most substantial success, effectively stabilizing the economy in the short run. Inflation rates moved down to 6.08 percent in July 1994, when the new currency was introduced, and further decreased to 5.46 percent, 1.51 percent, and 1.86 percent in the following months. The economy was essentially deindexed, and the inertial component of inflation controlled.

As compared with the sequence of previous plans, stabilization was achieved without price controls and without the disruption of financial contracts. Also, in positive contrast with past reform attempts, this effort was launched in the context of extensive trade liberalization, with the government in control of substantial foreign exchange reserves. In addition, the combination of the growth in consumption, driven by the end of the inflation tax, and investment demand made it plausible to expect that adjustment could be promoted without serious recession if a greater share of income could be channeled to savings, and if the pressure of public expenditures on the financial system could be reduced.

In the wake of the quick and sound successes of the Real Plan in reducing inflation, Cardoso was elected president by a comfortable majority in November 1994. His election ensured the continuity of the economic team in charge of the stabilization process. The leadership of Cardoso, combined with the work of the economic team, accomplished relatively successful technical and political management of the reform, and presented an adequate balance of credible commitments and credible threats to reduce uncertainty and induce cooperation from the major players in the society.

Nevertheless, by July 1995, a full year after the start of the plan, only limited progress had taken place on the structural sources of macroeconomic imbalance, and on this front, the associations with past experience in this effort were not encouraging. Unless these sources were promptly addressed, the danger of reversals remained close and real. Indeed, the public sector in Brazil had ceased to be financially viable. Macroeconomic reform thus remained, first and foremost, fiscal reform.

On the plausible assumption that the perpetuation of the fiscal disequilibrium is ultimately in no one’s interest, macroeconomic reform can be characterized as a collective action problem, requiring the collaboration of individuals or groups who have to make decisions involving complex intertemporal tradeoffs between costs and benefits. Voluntary collaboration, however, may be difficult either because of the uncertainty inherent in the intertemporality of the tradeoff, or improbable because of the nonexcludability clause (the free-rider’s hypothesis). Alternatively, the problem of reform can be seen as a classical prisoner’s di-
lemma game, in which high externalities, but insufficient information associated with key players' strategic choices, lead them to pursue suboptimal individual solutions, which ultimately leave all concerned worse off (J. Velloso 1993).

Uncertainty about future compensations, both positive and negative, and the need for complex coordination are the major obstacles to successful macroeconomic reform. Therefore, this reform involves high transaction costs that only effective governmental action can reduce. After a prolonged period of severe disequilibrium, these costs were exceptionally high in Brazil, because reform would imply substantial displacement of resources and captured rents, demanding an extended capacity from the state.

The government was able to mobilize enough capacity to curb spiraling inflation and stabilize the economy, but the exercise of this capacity remained insufficient for the task of fiscal reform. What were the nature of the obstacles and the identity of the major contenders, and their stakes, in this arena? The next section addresses the fiscal problem in more detail.

A Closer Look at the Fiscal Problem

Institutional History and Constraints

Brazil did not have a modern federal budget—in the sense of its rationality and universality, at least—until fairly recently. Until 1945, the Bank of Brazil combined both the fiscal and monetary functions, and those of a development bank as well. While there has been considerable institution-building since then, fiscal and monetary "promiscuity"5 prevailed until the enactment of the 1988 Constitution.

In 1964, the same law that created the Central Bank also created a monetary budget that was supposed to set annual ceilings for the off-budget credit operations administered by the monetary agencies—the Central Bank, Bank of Brazil, and federal commercial banks. The principle of multiple budgets was ratified, in open congruence with the constitutional principle of a universal federal budget, one that would include all federal revenues and outlays. In practice, the government covered its excess spending in the fiscal year through money creation, and after a 1971 Supplementary Bill, through unregulated open market operations by the Central Bank (Longo 1993b).

The difficulties in defining the responsibilities of different, and competing, government agencies largely reflected an underlying dispute among the monetary institutions, unwilling to let go of their power.6 The perpetuation of "promiscuity" and the existence of multiple budgets (there were still others, such as the Social Security budget, and the budget of the state-owned enterprises) invited the discretionary pressure of interest groups, and made it very difficult for the state to exert control over the public sector accounts.7 The very concept of a deficit was rather fictitious.

The Constitution of 1988 represented a marked advance in the prospects of increased rationality, universality, and transparency in the budgetary process. The monetary budget was eliminated, and a single federal budget incorpo-

---

5 The expression was used by ex-Finance Minister Mailson da Nobrega. This section relies to some extent on an interview with the minister.

6 Interview with ex-Finance Minister Mailson, himself originally a Bank of Brazil career official. He commented on the struggles of this institution in first resisting the creation of a Central Bank, and in subsequently assuring that its access to decisions concerning public expenditures was not greatly reduced.

7 These budgets were consolidated under the control of a new agency, the Secretaria das Empresas Estatais (SEST), in 1971, and were then approved annually by executive decree.
Table 8
Shares of Federal Income Tax (IR) and Industrial Production Tax (IPI) Allocated to Participation Funds (FPE and FPM)

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>IR + IPI revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FPE</td>
<td>5.0</td>
<td>5.0</td>
<td>9.0</td>
<td>14.0</td>
<td>19.0</td>
<td>21.5</td>
</tr>
<tr>
<td>FPM</td>
<td>5.0</td>
<td>5.0</td>
<td>9.0</td>
<td>16.0</td>
<td>20.5</td>
<td>22.5</td>
</tr>
<tr>
<td>FE</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
<td></td>
<td>—</td>
</tr>
<tr>
<td>FFR</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>IPI</td>
<td></td>
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<tr>
<td>FPEx</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10.0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IR</td>
<td>12.0</td>
<td>12.0</td>
<td>20.0</td>
<td>32.0</td>
<td>42.5</td>
<td>47.0</td>
</tr>
<tr>
<td>IPI</td>
<td>12.0</td>
<td>12.0</td>
<td>20.0</td>
<td>32.0</td>
<td>52.5</td>
<td>57.0</td>
</tr>
</tbody>
</table>

— Not applicable.

Note: FPE: Participation Funds for States and Federal (including federal territories until 1988). FPM: Participation Funds for Municipalities. FE: Special Fund (for states in poor regions). FFR: Fund for Financing the Productive Sector in the Northeast, North and Center-West Regions, managed by government’s regional banks. FPEx: Fund for the reimbursement to states (75 percent) and municipalities (25 percent) of tax deductions of industrial exports.

Source: Longo 1993b, p. 54.

rating all governmental credit operations previously in the control of the Central Bank and the Bank of Brazil was put in place. The deficit of all tax and credit incentives, including all export and sectoral subsidies, previously financed by the monetary budget, was consolidated into the overall public deficit in the single budget, which also incorporated the Social Security budget and the investment accounts of the state enterprise sector.8

Nevertheless, the same constitutional change that turned the federal budget from fiction into reality also compromised its viability, as well as that of the public sector in general. As seen earlier in this chapter, public sector finances were already debilitated by the inherited burden of the external and domestic debt—that is, by a state that could not control its growing expenditures, even in the face of stagnant revenues. The Constitution of 1988 legally committed the state to further expenditures and automatic transfers, in part by exacerbating problems already extant, without providing for a corresponding increase in revenues. Three main changes brought by this Constitution can be briefly identified to help us understand the nature of the fiscal problem in Brazil.

First, in an explicit move to increase the financial autonomy of the local governments, a significantly higher proportion of tax revenues was earmarked for transfers to the local states and municipalities, with no corresponding transfer of functional responsibilities or accompanying control mechanism, characterizing a process commonly referred to as chaotic or irresponsible fiscal federalism. Table 8 shows that although a movement toward decentralization had actually begun in the late 1970s, this latest constitutional decision left the federal government without nearly half the revenue of its most

8 Some implicit subsidies remain. Of those, subsidized agricultural credit and the alcohol subsidies from Petrobras are among the most visible.
productive taxes—the income (IR) and industrial production (IPI) taxes.

The political tasks of governors and mayors were made considerably easier, as evidenced by the budgetary increase in personnel expenses at the local level from 4.6 percent to 6.9 percent of GDP between 1987 and 1991 (Simonsen 1994). According to Athayde, as a percentage of their own tax revenue, the personnel expenses of local states and municipalities leapt from 23.9 percent to 84 percent in the 1970–90 period. In this author's words: “in addition to not receiving new charges from the government, the states and municipalities vastly increased their spending... with an evident political motivation and no attention to the usual financial precautions” (Athayde 1993, p. 190).

Interestingly enough, the increase in transfers did not arrest the mounting debt that local states contracted with the union, mostly through official state bank and Central Bank rediscouting schemes. In Athayde’s estimate, the states’ consolidated debt with the union was over US$50 billion by 1993. The new enhanced power of the local governments played a part in delaying and complicating the negotiations to correct this situation.

Together, the IR and the IPI accounted for over two-thirds of the fiscal budget, as seen in table 9. The high share of revenue automatically transferred away from the federal government provided it with little incentive to improve the efficiency of these taxes. Instead, it tried to compensate for the lost tax revenues with the introduction of several new, “exotic” taxes, with revenues that would not have to be shared with the other levels of government. Generally targeted at already overtaxed corporate income, these taxes have produced insignificant fiscal revenues, and “still helped pollute even further the confusing and unproductive tax network” (Athayde 1993, p. 190).

In addition to the automatic revenue transfers, a second major source of imbalance was added, related to the expansion of the so-called social expenditures. The politically salient concern of redressing the country’s “social debt” overrode realistic fiscal assessments in the writing of the new Constitution. As a result, it provided generously for the health, education, Social Security, and welfare programs through yet more compulsory and earmarked expenditures.

Education benefited from increased resources through an earmarked share of 18 percent (from 13 percent before 1988) of overall fiscal revenues net of the transfers to local states and municipalities. Unemployment compensation was given a specific financing source by earmarking 60 percent of the contributions to the PIS-PASEP annuity program; the remaining 40 percent of these revenues were destined for the National Social and Economic Development Bank (BNDES).

Social Security benefits were expanded both in coverage and scope, with a significant relaxation of the requirements to receive retirement benefits. Health coverage was made universal. Most revenues and expenditures for both Social Security and health were consolidated in the Social Security subbudget, which actually became a budget within the federal budget, financed by earmarked revenues of taxes that could not be legally shifted, regardless of position.

---

9 The new taxes included a surtax on the income tax, a social contribution on profit, and an income tax at source on profit.

10 Other examples of the new concessions include the four-month maternity leave and the five-day paternity leave, both with full compensation.

11 The health benefits included in the Social Security budget mainly cover medical treatment, which together with Social Security benefits proper constitute the programs administered by the National Institute of Social Security (INSS). Other components of the health program are supposed to be covered by other earmarked revenues, such as shares of the COFINS (a corporate tax for social expenditures) contribution and one of the profit taxes.
Table 9
Gross Tax Revenues by Level of Government and Main Taxes
Percent of GDP

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Major taxes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal budget</td>
<td>7.87</td>
<td>7.34</td>
<td>9.01</td>
<td>8.61</td>
<td>8.87</td>
<td>8.89</td>
<td>8.36</td>
<td>8.72</td>
<td>7.07</td>
<td>10.76</td>
<td>6.50</td>
<td>7.09</td>
</tr>
<tr>
<td>Income tax (IR)</td>
<td>3.08</td>
<td>3.17</td>
<td>3.74</td>
<td>4.03</td>
<td>4.44</td>
<td>4.47</td>
<td>3.72</td>
<td>4.11</td>
<td>3.95</td>
<td>4.37</td>
<td>3.20</td>
<td>3.37</td>
</tr>
<tr>
<td>Industrial value added tax (IPI)</td>
<td>2.14</td>
<td>2.10</td>
<td>1.96</td>
<td>1.25</td>
<td>1.74</td>
<td>2.07</td>
<td>2.34</td>
<td>2.03</td>
<td>2.04</td>
<td>2.38</td>
<td>2.15</td>
<td>2.28</td>
</tr>
<tr>
<td>Financial operations tax (IOF)</td>
<td>1.14</td>
<td>1.10</td>
<td>0.67</td>
<td>0.78</td>
<td>0.52</td>
<td>0.64</td>
<td>0.55</td>
<td>0.33</td>
<td>0.15</td>
<td>1.31</td>
<td>0.59</td>
<td>0.61</td>
</tr>
<tr>
<td>Other</td>
<td>1.51</td>
<td>0.97</td>
<td>2.64</td>
<td>2.56</td>
<td>2.17</td>
<td>1.71</td>
<td>1.75</td>
<td>2.26</td>
<td>0.93</td>
<td>0.28</td>
<td>0.56</td>
<td>0.83</td>
</tr>
<tr>
<td>Social Security contributions</td>
<td>7.80</td>
<td>9.06</td>
<td>8.29</td>
<td>7.03</td>
<td>6.96</td>
<td>8.18</td>
<td>7.07</td>
<td>6.33</td>
<td>7.38</td>
<td>9.59</td>
<td>8.33</td>
<td>8.50</td>
</tr>
<tr>
<td>Payroll-based contributions</td>
<td>5.36</td>
<td>6.25</td>
<td>5.48</td>
<td>4.70</td>
<td>4.56</td>
<td>4.96</td>
<td>4.56</td>
<td>4.12</td>
<td>4.28</td>
<td>5.01</td>
<td>4.39</td>
<td>4.52</td>
</tr>
<tr>
<td>Social Security taxes on sales (Fin-social) and profits</td>
<td>0.00</td>
<td>0.37</td>
<td>0.57</td>
<td>0.52</td>
<td>0.58</td>
<td>0.68</td>
<td>0.65</td>
<td>0.72</td>
<td>1.21</td>
<td>2.04</td>
<td>1.59</td>
<td>1.67</td>
</tr>
<tr>
<td>PIS/PASEP and FGTS</td>
<td>2.43</td>
<td>2.43</td>
<td>2.24</td>
<td>1.81</td>
<td>1.82</td>
<td>2.54</td>
<td>1.87</td>
<td>1.48</td>
<td>1.90</td>
<td>2.54</td>
<td>2.35</td>
<td>2.31</td>
</tr>
<tr>
<td>All other taxes</td>
<td>2.92</td>
<td>2.78</td>
<td>1.89</td>
<td>0.43</td>
<td>0.56</td>
<td>0.47</td>
<td>1.44</td>
<td>0.64</td>
<td>0.34</td>
<td>0.55</td>
<td>0.89</td>
<td>0.84</td>
</tr>
<tr>
<td>States</td>
<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ICM/ICMS</td>
<td>5.26</td>
<td>5.41</td>
<td>5.17</td>
<td>5.17</td>
<td>5.60</td>
<td>6.72</td>
<td>5.89</td>
<td>5.60</td>
<td>6.55</td>
<td>8.33</td>
<td>7.72</td>
<td>7.22</td>
</tr>
<tr>
<td>Other taxes</td>
<td>4.77</td>
<td>4.84</td>
<td>4.65</td>
<td>4.63</td>
<td>5.13</td>
<td>6.07</td>
<td>5.26</td>
<td>5.00</td>
<td>6.07</td>
<td>7.45</td>
<td>6.76</td>
<td>6.35</td>
</tr>
<tr>
<td>Municipalities</td>
<td>0.49</td>
<td>0.57</td>
<td>0.52</td>
<td>0.53</td>
<td>0.47</td>
<td>0.66</td>
<td>0.63</td>
<td>0.60</td>
<td>0.48</td>
<td>0.88</td>
<td>0.96</td>
<td>0.87</td>
</tr>
<tr>
<td>TOTAL</td>
<td>24.65</td>
<td>25.27</td>
<td>25.07</td>
<td>21.82</td>
<td>22.53</td>
<td>24.88</td>
<td>23.34</td>
<td>21.89</td>
<td>21.94</td>
<td>28.15</td>
<td>24.87</td>
<td>24.84</td>
</tr>
</tbody>
</table>

b. ICM: Imposto sobre Circulação de Mercadorias. ICMS: Imposto sobre Circulação de Mercadorias e Serviços.

Possible surplus, to finance other expenditures (most of the budget’s revenues were provided by payroll deductions; see table 9).

The new Social Security system took five years to implement. Expenditures for Social Security benefits alone, excluding health benefits, expanded by almost 80 percent in the period, primarily because of a rapid acceleration in the concession of unemployment benefits. While the growth rate of expenditures was consistently higher than that of revenues, however, it was only at the beginning of 1993 that expenditures sharply jumped up. In 1988 these expenditures represented 61 percent of total revenues in the Social Security budget, by 1991 they had grown to 77 percent, and in 1993 they reached 96 percent (R. Velloso 1994).

The collapse of the Social Security system followed. Transfers to the health program were squeezed to the bare minimum. While in 1991 the monthly average value of these transfers reached US$560 million, in 1993 this average was reduced to US$22 million (R. Velloso 1994). As a result, the program of public medical assistance was almost entirely paralyzed, and dozens of hospitals in the public system closed down throughout the country. Finally, in July 1993, the Ministry of Social Security, which controlled the collection and administration of Social Security contributions, retired altogether, on a de facto but
The third main element contributing to the fiscal problems in Brazil was the increase and rigidity in personnel expenditures. Here again, the impact of 1988 Constitution was quite detrimental to the prospects of sustained fiscal balance. Although there were no indications of expansion in government personnel, and wages and salaries had declined notoriously in the public service at the federal level, increased expenditures were brought about by: (a) the accumulated impact of inherited legal rigidities (in July 1991, about 31.4 percent of the federal government’s personnel expenditures were directed to retired and inactive federal employees) and (b) new constraints and obligations introduced by the Constitution.

Many of the new constraints derived from the new labor rights statutes in the Constitution, which applied to the country as a whole. Most relevant among those for the public sector accounts were the increased benefits for holidays (one-third of the value of monthly salary, in addition to the fully paid, thirty-day yearly rest period already established by law, and also the traditional 13th yearly salary previously guaranteed). Some constraints referred exclusively to the public service, including the automatic concession of job tenure to all employees with five years of service at the time the Constitution was enacted; extension of lifetime retirement benefits with full salary compensation to all public service employees; and the introduction of the right to salary “isonomia,” meaning equal remuneration to all equivalent positions across the public service.

As with the expansion of Social Security benefits, the Constitution inserted a “time bomb” with the issue of “isonomia.” It unleashed an intense and growing dispute over salary bases across the several areas and departments of the federal government. Given the wide discrepancies of salaries within the public sector—particularly among the branches of the federal government, with the prerogative of the legislative and judiciary branches to establish their own salary scales—the unwillingness of privileged and powerful sectoral bureaucracies, such as the state-owned enterprises, the Bank of Brazil, and the BNDES, to name a few, to even consider the possibility of salary reduction, and the disposition of the judiciary to enforce a rigid interpretation of the letter of the law, the federal government faced an uphill political battle of unlimited magnitude and consequence.

The Rigidity of the Budget

The fiscal problem in Brazil was not the outstanding magnitude of the deficit. In the early 1990s this deficit was nominally eliminated. Initially this was accomplished mostly through the gains brought by the full indexation of taxes. The impact of this mechanism declined, however, as inflation rates were substantially reduced. Except for the reduction of most fiscal subsidies and the improved efficiency in tax collection, most of the other deficit-reducing factors were inherently nonenduring. They included a sharp, but unsustainable, compression of wages and the postponement of crucial public investments and expenditures, including the solution of the Social Security crisis, which was simply left unresolved. In 1994 the government was also able to obtain congressional approval for additional fiscal revenues, but these were only temporary measures, such as the one-year tax on checks (IPMF) and the two-year Social Emergency Fund. Thus, the

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12 By 1994 the situation of the Public Health System in Brazil had become dramatic. There were frequent strikes by doctors and employees of the system in an effort to mobilize the population at large to increase the pressure on the government, and force a solution to this crisis. By that time the program of unemployment benefits administered by the labor minister had not yet managed to fully utilize the earmarked revenues it was allocated, leading to a cumbersome operation. The minister either invested its surplus revenues in government bonds, or lent back money directly to the federal government to help fill in the gaps described above.
deficit was not structurally eliminated, and the sources of imbalance remained and were bound to surface again.

The fiscal problem could be better defined in the difference between the *growth tendencies of fiscal revenues and expenditures*. The downward rigidity of expenditures led to a rather dramatic narrowing of the maneuvering margin of government in the preparation of the budget. The combined effect of the automatic transfers to the local states and municipalities, the earmarked expansion of the social expenditures, and the rigidity of personnel expenditures left the amount of uncommitted or “free” revenues at the discretionary control of the government greatly reduced.

According to R. Velloso (1993), free revenues had declined from 4.8 percent of GNP in 1987 to 0.4 percent of GNP in 1993 (table 10). Velloso’s index of free revenues refers to the difference between the total (nonfinancial) fiscal revenues and the sum of earmarked (transfers and others) and rigid (personnel) expenditures. Note that the sum total of “free” revenues corresponded to the remaining available fiscal resources to cover all expenditures under the budget item “other costs and capital,” which should include the expenditures net of personnel of all other ministries not benefiting from earmarked revenues: the Transport, Communications, Agriculture, Regional Integration, and military ministries. It should also include the servicing of the public debt.

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**Table 10**

**Federal Government “Free” Revenues**

Nonfinancial revenues and expenditures, percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th>1987</th>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Total revenues</td>
<td>14.7</td>
<td>14.5</td>
<td>16.8</td>
</tr>
<tr>
<td>1.1. Fiscal revenues</td>
<td>9.6</td>
<td>7.2</td>
<td>8.7</td>
</tr>
<tr>
<td>1.2. Social Security revenues</td>
<td>5.1</td>
<td>7.3</td>
<td>8.1</td>
</tr>
<tr>
<td>1.2.1. Payroll contribution</td>
<td>4.5</td>
<td>4.5</td>
<td>4.8</td>
</tr>
<tr>
<td>1.2.2. Other</td>
<td>0.6</td>
<td>2.8</td>
<td>3.3</td>
</tr>
<tr>
<td>2. State and municipality transfers</td>
<td>1.9</td>
<td>2.6</td>
<td>3.0</td>
</tr>
<tr>
<td>3. Other earmarked revenues and transfer obligations</td>
<td>0.7</td>
<td>0.9</td>
<td>1.3</td>
</tr>
<tr>
<td>4. Personnel expenditure</td>
<td>3.3</td>
<td>4.0</td>
<td>4.4</td>
</tr>
<tr>
<td>4.1. Covered by earmarked revenues</td>
<td>0.7</td>
<td>1.7</td>
<td>1.9</td>
</tr>
<tr>
<td>4.2. Covered by ordinary revenues</td>
<td>2.6</td>
<td>2.3</td>
<td>2.5</td>
</tr>
<tr>
<td>5. Net revenues (1.1 + 4.1-2-3)</td>
<td>7.7</td>
<td>5.5</td>
<td>6.4</td>
</tr>
<tr>
<td>6. Social Security benefits</td>
<td>2.6</td>
<td>3.6</td>
<td>4.8</td>
</tr>
<tr>
<td>6.1. Financed by Social Security contributions</td>
<td>3.0</td>
<td>3.0</td>
<td>3.2</td>
</tr>
<tr>
<td>6.2. Surplus/deficit of the post-1988 additions (6 - 6.1)</td>
<td>-0.4</td>
<td>0.6</td>
<td>1.6</td>
</tr>
<tr>
<td>“Free” revenues (1.1-2-3-4.2-6.2 = 5-4-6.2)</td>
<td>4.8</td>
<td>0.8</td>
<td>0.4</td>
</tr>
</tbody>
</table>

**Structural indicators (percent)**

<table>
<thead>
<tr>
<th></th>
<th>42.8</th>
<th>73.8</th>
<th>69.3</th>
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<tbody>
<tr>
<td>Personnel expenditures/“net” revenues</td>
<td>57.8</td>
<td>79.7</td>
<td>99.3</td>
</tr>
</tbody>
</table>

The reduced share of free revenues and the extraordinary rigidity of the fiscal budget underscored the extensive fragmentation of power resources that had taken place in the fiscal area. It also exposed the deteriorated political position of the government in relation to beneficiaries of earmarked revenues, and its reduced ability to control public sector accounts. If inflation was to be avoided, the state could not realistically balance the budget without resort to financial acrobatics of one sort or another, as well as further compression of critical investment in the infrastructure and social areas.

Behind the overall rigidity of the fiscal budget was the interplay of the several interest groups, in and out of the state, who either benefited immediately from the transfers and earmarked revenues, or feared they might lose with major and unpredictable changes. Governors and mayors, sectors of the public bureaucracy in control of fiscal resources or privileged salary positions, and the lobbies of economic groups with major vested interests in public expenditures engaged in predatory political disputes over control of fiscal resources. This dispute was played out in Congress whenever a government fiscal adjustment proposal involving expenditure cuts was submitted for approval. It was enacted once more during the debates and the negotiations of the fiscal reform proposal in early 1994, with results that fell quite short of government expectations.

**The Fiscal Reform Attempt and Its Aftermath**

The fiscal reform package presented by the government to Congress in December 1993 consisted of twin initiatives of proposed budget cuts and revenue increases. It represented an attempt to close the estimated 1994 budget deficit of approximately US$16.5 billion, without recourse to inflationary deficit financing. The package was also intended to produce funds to finance some social and capital expenditures not covered by automatic transfers, and which the government concluded could not be compressed further. In addition to the budget cuts, the main element of this package was the proposed creation of a Social Emergency Fund of US$15.8 billion, US$9.3 billion of which would contribute to balancing the federal budget, with the remaining funds directed to the above-mentioned expenditures.

Significantly, the reform package did not represent an enduring solution to the country’s fiscal impasse, but was meant as a two-year-long emergency measure, considered essential to provide the “preadjustment” conditions for the subsequent stages of the stabilization reform. The Social Emergency Fund, as originally conceived by the government, was to be financed by a 5 percent increase in all federal taxes, by the government’s retention of 15 percent of the revenue to be transferred to the states and municipalities, and by a further retention of 15 percent of all federal tax revenues. With these last two measures, the government intended to escape from the earmarking mechanism and increase the amount of “free” revenues in its control. Both these measures required congressional approval of constitutional amendments.

The trajectory of the fiscal reform in Congress was highly problematic, and ultimately offered little reassurance to the government. Increasingly watered-down versions of the package were put together and sent to Congress, and were met with strong resistance from all political parties and the lobbies of the interest groups affected. The proposed cut of 1.5 percent of GDP in the federal budget proved unrealistic. The military managed to engage the president’s support in eliminating the US$700 million cut in their budget, and several other ministries convinced Congress to increase their allocations. The judiciary resorted to the Supreme Court, which declared the proposed cuts unconstitutional. Ultimately, lack of even minimal agreement rendered the prospects for any budget almost nil; the 1994 federal budget was only approved in November of 1994.
The Social Emergency Fund proved similarly controversial. As the prospects for approval of the necessary constitutional changes became complicated, and different versions of the amendments were drafted and submitted, the government separated the original package and introduced some measures by executive decree (some of which the Congress later managed to reverse). Others were sent in the form of regular bills. Intense and lengthy negotiations undermined the government’s intention to finally get the constitutional amendments approved in December, so that they could take effect in the 1994 fiscal year. The political opposition to the retention of state transfers was overwhelming and widespread, and included even parties and state governors who had supported the finance minister and the stabilization plan. The version of the fund that finally emerged out of this intense dispute bore little resemblance to the original concept, and made no further mention of state transfers. It did, however, include a 20 percent retention in federal tax revenues, after transfers, which guaranteed a limited operational margin for the executive for the next two years.

The fiscal reform episode allows for a schematic identification of groups with a major stake in blocking reform efforts. They included many of the states and municipalities; several of the government ministries; some sectors of the public bureaucracy, including state enterprises and official banks; and the judiciary. Economically weak states would be among the most affected by the proposed cut in transfers (table 11 shows their dependency on the States Participation Fund, FPE, making it easy to understand why they were likely to be fierce opponents of any reversal of fiscal transfers). What this listing suggests is that most of the main obstacles to fiscal stability came from within the state apparatus itself.

The complicated course and modest results of this limited reform attempt also provided some clues to the degree of difficulty surrounding a more comprehensive initiative to introduce enduring changes in the fiscal areas. Comparative research has already shown that successful stabilization is usually associated with a concentration of power in the executive at the expense of the other branches of government, particularly the Congress. Within the executive, it is the power of the financial bureaucracy that is typically strengthened in relation to that of the “spending” ministries (Bates and Krueger 1993, pp. 462–63). The substantial fragmentation of power within the Brazilian state as result of the fiscal constraints introduced by the 1988 Constitution and the weakened capacity of the state since the early 1980s to withstand extensive penetration by powerful interest groups had left the president and the economic team in charge of the reform process without control of the necessary policy instruments to promote fiscal reform.

The challenge of fiscal reform was therefore compounded; it now hinged on generating strategic political support for significant institutional changes. These changes included, first, a reversal of recently enacted constitutional principles guaranteeing the concession of benefits and prerogatives that were dear to a wide and powerful constituency of interests. But they also included a major restructuring of the public sector, which involved both the privatization of state industrial, financial, and infrastructure-related assets and a drastic reorientation in the ingrained patterns of operation of the core official financial institutions to eliminate their use as instruments of political patronage and off-budget public sector financing. Given the complexity of the fiscal problem, the actual requirements of macroeconomic reform in Brazil blurred the conceptual distinction between measures designed to promote stabilization and policies associated with the promotion of structural changes.

Following the reform attempt of early 1994, significant achievements in introducing fiscal change would remain elusive for at least a year and half longer, imposing a heavy toll on the course of the stabilization process. The scope of
fiscal policy was reduced to slowing the flow of unavoidable payments and transfers and compressing non-earmarked expenditures to the limit. The maneuvering margin of the government in this area, however, was progressively squeezed by the sharp deterioration of public services. Moreover, the efficacy of the various means utilized for this control substantially decreased with

<table>
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<th>State</th>
<th>Percent of GDP</th>
<th>FPE shares</th>
<th>Total transfers</th>
<th>State tax revenues</th>
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Note: (1) Distorted percentage. Some states use outdated methodology. (2) Data exclude investment-related transfers.
Source: National Treasury, IBGE.
the very success of the Real Plan in curbing inflation. The conduct of macroeconomic reform, which should have been anchored in an active fiscal policy, was forced to rely mainly on the combined impact of import liberalization and an overvalued exchange rate to keep inflation down. The resulting distortions—a deteriorating trade balance and an overheated domestic market—led the government, in March 1995, to practice a much stricter monetary policy, slowing down the high rate of economic growth, which had reached 10 percent in the first quarter of that year.

The ability of government to rely on a substantial amount of accumulated foreign exchange reserves and the reasonably positive reaction of domestic industry to extensive import competition were no small testimony to the prior adjustment, which had begun to take effect in the economy in 1991. Yet by 1995 this economy was threatened by induced recession to compensate for seemingly intractable difficulties in adjusting public sector accounts. The resilient macroeconomic problem in Brazil, in both its substance and potential solution, was essentially a political problem, or a problem of the state. Not only was fiscal reform inevitably associated with a reform of the state, a redefinition of its optimum size and attributes, but the promotion of reform was also contingent on a substantial re-grouping of the state's governance capacity. The next pages will focus on the origin and nature of the constraints underlying the functioning of the Brazilian state.

The Governance Capacity of the State

The Process of Shrinking Capacity

This chapter suggests that the origins of declining governance capacity in Brazil lie in the over-expansion of the scope of the state in society, most notably since the mid-1970s. There may be distinct dynamics underlying state expansion. In the political rationale of this process, I have argued that scope may be expanded as a means of maximizing capacity, a form of power-enhancement and conflict management that includes the creation and distribution of rents, or, as Bates would put it, the generation of clients (Bates 1990; Frischtak 1994).

Nevertheless, as the state is penetrated by its clients, as its resources are committed and appropriated, the state often finds its choices reduced, or its maneuverability margin compressed. It may prove difficult to reverse policy directions or correct policy mistakes if these decisions imply substantial displacement of rents, jobs, and other resources. Thus, there is an underlying tension between scope and capacity, and this tension refers to control. An overexpansion of scope without a corresponding increase in capacity may lead to fragmentation, erosion of power, and loss of control. What follows is a short sketch of an argument of how this process may have evolved in Brazil.

Although the scope of the state had been expanding quite consistently in Brazil since the 1930s, it was in the latter part of the 1970s that it seems to have accelerated markedly ahead of capacity. The years between 1964 and 1967, the inaugural period of a two-decade-long military regime, can be understood as an adjustment period. The expansion of scope was temporarily halted, control over resources was reestablished, and the basis for governance capacity redefined. The events of the mid-1970s following the first oil crisis surely provided another adjustment opportunity. In what was probably a rational decision, however, considering the information available at the time (Malan and Borelli 1992), it was settled that the country would "grow" out of the crisis, making use of cheap and abundant external financ-
ing through massive investment in capital goods and infrastructure, in the optimistic assumption that the new export capacity to be generated would make it possible to pay for the contracted debt.

What followed was a major expansion of the state’s scope, in accordance with the major goals of the second National Development Plan (PND) of 1974:

Among the instruments utilized since 1974...[two] can be seen as determinants of the problems to come in the following years: on the one hand, the generalization of subsidies, and on the other, the expansion of the state apparatus, through the generation and enlargement of the public enterprises [Castro 1983, p. 130].

The option favored—that of promoting growth through the extension of scope—was the politically easier one, because it had the advantage of avoiding the rent displacements and sectoral clashes that an adjustment would have implied. In hindsight, however, the state could still have made use of a balanced supply of capacity to adopt the alternative course. By the time this game was played again, on the occasion of the second oil shock of 1979, this capacity had substantially deteriorated.

The political legacy of the second PND launched in 1974 was the generation of a greatly increased constituency of interests, lodged within and around the state, that were quite dependent on its resources and extremely unwilling to accept any change in the status quo. In some instances these interests had been invented by the state, as was the case with the petrochemical industry. Conceived and designed entirely by the state on the basis of its strategic importance, this industry could later claim the continuous commitment of state resources. The state had built an industry only to become its hostage.

Thus, the external vulnerability of the country, in the form of a substantial and suddenly much more expensive debt, corresponded to an increased domestic political vulnerability with its clients. The 1979 replacement of “recessionist” Finance Minister Simonsen—who, for six short months, tried to implement a minidevaluation, reduce fiscal and credit incentives, control public expenditures, and strengthen the autonomy of the Central Bank to control monetary policy—is instructive. The post was taken by the “developmentalist” Minister Delfin Neto, and macroeconomic policies turned once more in the expansionary direction, which underscores the intense pressures exerted by business, labor, the state enterprise sector, and the heads of various government ministries to avoid the path of a recessionary adjustment (Moura 1990).

The aborted 1979 adjustment opportunity had a critical and lasting impact on the country’s economic performance for the following decade. It also locked the state in a pattern of interest group politics that would be difficult to change. The outstanding antiadjustment policies pursued at the turn of the decade—acceleration in public sector expenditures, notably in the state enterprise sector; monetary and credit expansion; return to price controls for industrial goods; and introduction of a semiannual wage indexation system, to name a few—cannot be construed as realistic economics, even without the prejudice of hindsight.

As seen in the beginning of this chapter, for the remainder of the decade the state continuously avoided effective adjustment, at ever increasing economic and political costs. Meanwhile, capacity sharply deteriorated, and interest groups clung to their rent-controlling positions. Considerable political capital was wasted in a succession of policy failures, of which the Cruzado Plan is the

13 This same process is repeated once more in the 1980s, with the creation of the informatics industry in Brazil.

14 Minister Delfin Neto, on taking office, made an emblematic comment to the nation: “Tighten up your seat belts, Brazil is going to take off.”
most notorious, eroding government credibility. The Brazilian history of postponed adjustment in the 1980s is also a history of deteriorating capacity. In this period another political process, that of the political transition from military rule to a democratic government, intersected with this history.

**The Political Transition to Democracy**

While the 1980s were the lost decade in economic performance, it was also the decade when Brazilians regained a democratic political regime, bringing to an end twenty years of military rule. With the reemergence of democracy, the country scored a number of political victories. Not the least of these achievements was the gradual and carefully negotiated transition process, which avoided the disruptive effects that a violent break with the outgoing regime would impose on the political institutions and the economy. Indeed, even if the first popularly elected civilian president only took power in 1990, during most of the decade the political attention of the country was given to the process of political transition.

Nevertheless, the prospects of economic reform in Brazil did not benefit from its coincidence with political change. The political challenge of devising and putting in place an entirely new political system, including the task of creating a new Constitution, crowded out, or relegated to secondary importance, all other pressing issues on the country’s agenda. But in the more specific area of economic policy choices, there was little momentum for a critical examination of the previous development model, which was still officially in place, albeit lamentably nonperforming. Therefore the industrial policy strategy was not challenged in its basic conception, inward orientation, and, least of all, in the pivotal role played by the state. Inflation, left over from the previous regime, was not causally or structurally related to the performance and form of financing of the state by policymakers or the public: both favored external and circumstantial causes. Only a few of the economic features of the previous regime were contested, in particular, its negative equity bias. As with many political movements that indulge in simplifying Manichaeanism, income concentration made a good match with political exclusiveness, and both were blamed on the military.

The problem of the transition is of critical importance in understanding the evolving political and economic situation in Brazil. A redistributive concern not anchored to any consideration of performance of the state or the economy gained prominence in the transition process. Thus democracy brought about widespread demands to access the state’s resources, directly or indirectly, although the state neither had, nor was the economy producing, resources to distribute. The political transition taking place in the midst of a recessionary economic environment aggravated the weaknesses of a state that was already deeply penetrated and captured, and also contributed to the perpetuation of the conditions of macroeconomic instability. Two tendencies in this transition can be highlighted; both arose in reaction to the previous years of military authoritarianism, and both underscore the problems of effecting a change of political regime in the context of debilitated state capacity.

The first notable tendency was the overload of the political agenda. The political salience of the deficit accumulated by the previous regime in addressing long-standing social issues, and the equity question in general, added to the need to

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15 When new political regimes come about with a mandate to resolve an acute economic crisis, and actually promote reform, as happened throughout Eastern Europe and in some Latin American countries, these regimes can enjoy a grace period, the so-called honeymoon effect. As these stories are unfolding, however, some of these honeymoons did not last long enough to generate the conditions of sustainability of reform. See Nelson 1994 for an account of how democratic transitions have intersected with economic reform in six different countries.
respond to the direct pressure of a large number of interest groups, led policymakers to attempt to gain legitimacy by “multiplying the numbers of issues subject to public debate and decision.” Thus, “instead of striving to aggregate interests and negotiate a broad settlement,” politicians actually desegregated them, overheating expectations, which were bound to be frustrated (Lamounier 1994, p. 42).

In addition to further radicalizing demands, this tendency significantly contributed to the decisional paralysis in the government and its decreasing credibility. More important, it played a major role in the design and writing of the extremely ambitious, over-detailed, and binding 1988 Constitution. This document, although it represented undeniable gains in a number of areas, was elaborated without any orienting frame by a large constituent assembly lacking in cohesion, and it ended up resembling a mosaic of the demands of the organized interest groups (Kinzo 1990). The lack of structure and accepted parameters led to inconsistency and a lack of realism in the document.

A second major tendency was toward a marked and multilayered fragmentation of power and its resources, both institutional and financial, in the political system (Goes 1992). In the aggregate, this fragmentation took place simultaneously at the expense of the executive, the major political parties, and the larger and wealthier local states. There were, however, different and intertwining processes of fragmentation at work, each generating different and often conflicting constituencies.

Congress and the judiciary were endowed with increased decisional authority, in sharp contrast with the subsidiary and largely symbolic role they had played when the executive concentrated all authority in the military regime. Both would make increasingly frequent use of this new authority to block or reverse presidential decisions and decrees.16 The executive was politically weakened, and the federal government lost significant financial resources to the states and municipalities, as seen in the previous section.

Relaxations of restrictions concerning the party system favored the proliferation of small political parties, facilitated the frequent transit of representatives across parties, and otherwise conspired against the establishment of “stable” voting majorities in Congress, aggravating the traditional “structural weaknesses” of the party system (Kinzo 1990). The electoral laws, based on a modified system of proportional representation, guaranteed that the small, less-developed states of the northeast and central-west were overrepresented in both parliamentary houses.

Political and economic inclusiveness were, and will probably remain in the near future, the most pressing problems to be included in the agenda of any comprehensive reform program with genuine claims to social legitimacy. The democratic transition was influenced by a political culture that placed the redistributive issue at center stage, but little attention was given to the implementation capacity of the state. Lamounier identifies this political culture in the elaboration of the Constitution, where an indiscriminate rejection of the past was manifested in the “legislators’ desire to abolish economic and social inequalities through the law” (Lamounier and Souza 1990, p. 88). The same redistributive concern is associated with power resources. The tendency toward fragmentation, the pulverization of power, is associated with demands for greater equality of access to decisions. The balance was tipped, however, because this tendency resulted in a lot more access than decision. The system that finally emerged can be described as faulty

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16 Lessa (1994) blames a certain political culture of the transition for an overvaluation of the legislative branch, and for its instrumental effect in the weakening, submission, and loss of prerogatives of the executive.
consociationalism: consociational insofar as it was based on a multiplicity of vetoes and counter-weights, oriented to prevent the formation of powerful majorities (Lamounier 1992, 1994), and faulty because the arbitration mechanisms were missing.17

In this manner, in roughly a decade, Brazilians managed to effect a peaceful transition to fully democratic rule, with free and highly competitive elections at all three levels of representative government and an unrestrained press, and to engage in extensive democratic institution-building, including a new Constitution, a strengthened Congress, and an independent judiciary. This was no minor accomplishment. Yet in the process there emerged a system beset with decisional paralysis, unable to aggregate interests, but oriented toward the proliferation of powerful “veto” minorities in Congress and a myriad of organized interest groups, large and small, with the capacity to block initiatives in all major decisional arenas.

Early in 1994—just four years after the first popular presidential election, and six years after the new Constitution was enacted—an ambitious initiative to reform the Constitution was launched by the executive, with the support of most of the political parties. By then there was widespread and acute public perception that the political system did not work, that the state was unable to perform many of its functions, or, as in the most popular rendition of the theme, that there was a serious crisis of governability in the country. The constitutional reform was conceived and presented by the executive as an urgent and essential task to restore governability. The reform proposal attempted to eliminate many of the rigidities and constraints in the text of the Constitution that stood in the way of the government’s main policy agenda. Most salient in this agenda was macroeconomic stability.

The story of the constitutional reform effort in Congress turned out to be a rather spectacular defeat for the government. It happened under the blaring lights of a proreform media, which joined with the government to galvanize public opinion in their favor. For three consecutive months the television cameras exposed the empty seats of representatives nightly, even though intense negotiations took place throughout the period between party leaders and government officials to guarantee the necessary quorum for the approval of the reform measures. Although the government repeatedly adjusted downward the number and scope of the originally proposed measures, only a few of the less important initiatives were finally approved before the episode came to an end. It seemed that, once more, veto democracy had taken its toll on government credibility.

Institutions and the Governance Problem

The emphasis given by the government and those supporting it to the constitutional constraints on economic and state performance favored an understanding of the deficient state performance that emphasized its institutional aspects. According to this understanding, the institutions that currently compose the state do not provide it with the means to process existing demands. Inadequate institutional rules and arrangements should explain both the undersupply of these means and the distorted increase of the demands; they were also supposed to explain why institutional reform did not take place.

17 The thesis of political fragmentation leading to decisional paralysis commands strong support among Brazilian analysts, but it is not consensual. Santos, for instance, maintains that parliamentary fragmentation does not result from the number of parties (currently eighteen in Brazil), but from the distribution of parliamentary power—as expressed in the number of seats—among these parties. “Thus, a bipartisan system can achieve maximum fragmentation if each party holds 50 percent of the seats in parliament, whereas a multiparty system can have little fragmentation, as long as parliamentary power is concentrated in one or two parties” (Santos 1994a, pp. 9–10).
There is an undeniable and serious institutional deficit in the country that constrains the capacity of the state. This chapter has tried to characterize this deficit both in terms of fiscal and political constraints. Institutional constraints, however, cannot entirely account for the general shortages of capacity of the state, nor for its more specific difficulties in promoting economic reform.

In essence, institutions represent operational rules and norms. They can be written or unwritten, legally established or culturally internalized, codes of conduct. They can be encapsulated in organizations and agencies, which may exist primarily to enforce them; thus these organizations can be called institutions as well. Institutions can still be thought of as patterned interactions; as such they contain, as well as constrain, behavior. Yet they do not exhaust possible behaviors. Reducing the problem of the state to the quality of its institutions may leave a number of variables that affect its capacity uncharted, such as leadership, political will, the exercise of authority, and political strategy, or statecraft. It also may make it particularly difficult to explain political and institutional change.

A useful approach to governance should capture this more behavioral dimension as well, by allowing us to focus on the dynamic exercise of governing, and not only on its institutional constraints and possibilities. Governance capacity at any given time could thus be explained by the interaction between institutional constraints and behavioral attributes and the capabilities of states that are less tangible, and more volatile. Established and smoothly functioning institutions, such as an independent judiciary, a representative parliament, and a competent and professional civil service, constitute insurance against the vagaries of credible and politically able leadership, but they can never fully compensate for its absence.

Accordingly, governance is also manifest in the capacity of the state to politically coordinate interests that effectively constrain policy decisions, engaging their cooperation as well as managing conflicts among them. Governance may depend greatly on leadership's capacity to make and sustain choices that may involve political risks, and its ability to provide and communicate to the larger society the general direction of the policymaking process, as well as to make this process consistent across the different areas of government. Credibility, another crucial governance component, lies in the state's ability to induce the belief that it is capable of effectively doing what it says it will do. Governmental credibility is not merely an intermittent phenomenon, attached only to punctual decisions and policy announcements, but also refers to society's expectation that the government will provide order according to existing law and guarantee the functioning of its institutions. Credibility is closely connected to the implementation capacity of the government and its reputation; nevertheless, perceptions are shaped by politics, and credibility needs to be effectively communicated.

Legitimacy is far too complex an issue to be characterized in brief statements, but it may well be the single most important determinant of capacity. Here, too, perceptions are of considerable importance. No system of interest aggregation and representation can render the policymaking process entirely transparent or eliminate the substantial latitude of the government in the "interpretation" of the public interest. Governmental legitimacy is largely contingent on society's implicit acceptance that the decisions about policies or initiatives reflect, in the aggregate, the state's understanding of the public interest, although there may be considerable disagreement over the content of the decisions.

18 For an interesting argument on the misguided statecraft of the Brazilian estate, see Werneck 1993.
Governance is most often associated with the state's capacity to implement its policies and decisions, and this capacity is usually linked to the technical and professional quality of the government bureaucracy (Gueddes 1994). But implementation capacity also depends on the consistency between decisions and the availability of the technical, administrative, and political resources these decisions require; thus it depends on the quality of the information held by policymakers about these resources. In addition, implementation capacity requires the operational autonomy of the agencies and departments of state from the arbitrary and ad hoc influence of external and special interests.

The problem of capture constrains governance capacity in many different ways. It can substantially undermine the legitimacy and sabotage the implementation of state policies. States that are captured by some powerful interest groups at the expense of all others, or by the paralyzing dynamics of the conflict among these groups, cannot effectively exercise political coordination or leadership. They can neither control their own resources nor impart an overall direction to policymaking that serves the long-term and inclusive interests of society.

Thus, while the exercise of governance is considerably constrained by the existing institutional structure, governance cannot be automatically deduced from this structure. Rather, the exercise of governance can interfere in this structure as well, enlarging and reshaping the "policy space" in which states operate (Grindle and Thomas 1991). In summary form, it is possible to understand governance as the capacity to conceive and propose a political agenda, make it intelligible and meaningful to society, and generate the necessary political, administrative, and financial resources for its implementation. Given an incongruence between the agenda and the existing institutions, the political ability to effectively lead the process of change becomes a reasonable test of governance capacity.

Crisis and A New Opportunity for Political Regrouping and Economic Adjustment

As the government struggled unsuccessfully with the constitutional reform attempts of 1994, political analysts converged in identifying a crisis in the erosion of the power and administrative resources of the state. Several of these analysts echoed an understanding of the governance problem similar to that described above. Santos, for instance, argued: "Were the political institutions different—in form of government, electoral and party systems—the country would still be facing the same problems. [Institutions] are not the weakest chain in the present historical conjunction. What makes . . . [this moment] singular is the asymmetry between the fast achieved degree of political and social democratization, and the incapacity to invest the state with political will" (Santos 1994b, p. 79).

According to Faucher, "the question of the political crisis [could] not be resolved through the examination of the constitutional attributions, nor on the basis of the adequate character of the institutional framework, or [of] the party system . . . . The Brazilian crisis is also a crisis of political authority, which paralyses the decision making system . . . . It is the manifestation of what I call the erosion of the estate. The government not only lost the means of action, but also the authority to act" (Faucher 1993, pp. 394–95). And Marques contended that the crisis in Brazil begins by the absence of general government—that is, government exercised in the perspective of the global society—and culminates with the interest groups acquiring enough strength to confront the state with true veto power, or counterpower. The state is far from representing the public interest, the interest of the population as whole, and has pegged itself on the interests of groups, corporations, and factions (Marques 1992).

Indeed, by the early 1990s, the Brazilian state had become anemic in its capacity to exert lead-
ership and promote the coordination of interests; as a result its behavior appeared inconsistent, fragment, ad hoc, entirely demand-driven, and captured. The decisional deficit had become large, and increased with the frequent reversal of decisions that threatened to involve significant political risks. There was continuous difficulty, or political reluctance, in the clear articulation of a general direction for the policy reforms attempted. To the extent that a conscious commitment to a comprehensive reform program may have existed in parts of the state bureaucracy, it did not manage to supersede all the competing noise in the political environment, and it was not made clearly intelligible to society.

Control over the government bureaucracy had become incipient, which explains the overt defiance or sabotage of the implementation of the executive’s decisions by the bureaucracies, particularly state enterprises and regional public banks (Sola 1994). The government lacked adequate knowledge of the available means and resources that should have informed its decisions, which explains the frequency of court challenges to their legality. Lessa, in arguing that the operational capacity of the executive had been “practically destroyed,” called attention to the fact that the internal structure of the government was virtually unknown: “It is not only the common citizen and the professional analyst who ignore the topography of the ruins of the government; the decision makers themselves also ignore it” (Lessa 1994, p. 18).

All the above contributed to the low credibility of the state, and to the widespread skepticism over the capacity of the state to maintain order and manage its own institutions. After the impeachment of President Collor in 1992, the government proved unable to capitalize politically in a lasting manner on what was an undeniable victory of its democratic institutions. Instead, there was a cascade of corruption scandals involving both Congress and sectors of the bureaucracy, although only a few minor charges were ever pressed. Meanwhile, governmental policies and initiatives were increasingly associated with influential groups, providing other groups, and society at large, with strong incentives to not cooperate. The state faced mounting difficulty in having its decisions associated with the public interest.

Institutions arise to economize on transaction costs. But setting up the institutions generates costs as well. To put it differently, the explanation of why institutions exist is not necessarily the same as that of how they came to be (Moe 1990). The reforms in the government’s political agenda—the constitutional and the fiscal reform—remained essential to the restoration of the institutional conditions of governance. Yet restoring capacity in some critical political and dynamic aspects was an essential precursor to institutional reform.

The political and economic developments of early 1995 were promising signs that just such a regrouping in state capacity might be starting. The election of Cardoso to the presidency, his political talent for negotiation and leadership, the credibility of his economic team, and, above all, the indisputable initial accomplishments of the Real Plan in halting inflation combined to swing the country’s political mood to a radically different direction. Brazil is indeed a country of surprisingly rapid and drastic changes. Whether these changes can stay their course and deliver enduring results, however, is an altogether different proposition, as the popular support and optimism that greeted both the Cruzado and the Collor plans in the past should remind us.

Improved governance content was undoubtedly evidenced in the political and economic achievements of the early Cardoso era. Nevertheless, state capacity still suffered from chronic debility, and improvement was of a partial and vulnerable nature. Indeed, these achievements did not present more than an opportunity for effective change, which could not take place unless the increased credibility acquired with the early successes could be politically mobilized for swift and decisive initiatives in the promotion of institu-
tional and fiscal reforms. In the first half of 1995, the government, opting for a gradual and nonaggressive strategy, managed to pass several minor constitutional changes in Congress; while resistance was organized in congressional trenches, all the significant and politically difficult measures of change, such as revoking automatic tenure for all public employees and tax reform, were postponed.

The economic policy achievements of the 1990s placed the Brazilian experience in a context similar to that of several other reform processes where the real and more politically difficult challenge remained that of building the institutional “fit,” or “institutionalizing,” the changes to make them sustainable. Nevertheless, given the pressing nature of the fiscal and constitutional constraints in Brazil, time was not on the side of reform. In other words, the test of institutional reform on governance capacity came too soon in the Brazilian adjustment process, compounding its difficulties.

Paradoxically, however, it was exactly the pressing nature of the challenge of institutional reform that made it more feasible. It reduced the government's margins of error, and made it possible for this government to request a broader mandate for change from society. It also turned this process into a prime opportunity to reduce the overextended scope of the state, redefining its functions and increasing its governance capacity.

Concluding Remarks on Capture and Visions

This chapter has not fully answered a few salient questions. How, for instance, does one move from control to capture, or how does one differentiate the patronage and rent distribution of the relatively “capable” Brazilian state of the 1960s and early 1970s from the same patronage and rent distribution of the “captured” state of the 1980s and 1990s?

The Brazilian state had become captured, not by one or two very powerful groups or the distribution of rents and patronage, but by the fragmented dispersion of power resources, which the state no longer controlled. Loss of control meant that the rents and patronage could not be used as instruments of power, mechanisms of political coordination, or policy inducements by the government, but that rents and patronage became power assets to the recipient private interests. While the party system proved unable to effectively translate and channel interests, these interests operated directly at all levels of decisionmaking: in Congress, through powerful lobbies that cut across party lines, and within the bureaucracy through the networks of patronage. Indeed, clientelism had penetrated the governmental bureaucracy so extensively that it was often difficult to discern the limits between the state and private interests.

Capture meant the reduction of choices available to the state, the reduction of its maneuverability margin or its decisional capacity. The state may not be able to make decisions, and when it does make them, may not be able to implement them. Capture would also mean that the state has lost its capacity to coordinate or to aggregate interests. This chapter has tried to characterize the two most salient political impasses in Brazil—those of fiscal and constitutional reforms—in terms of a shortage of governance capacity. Accordingly, the fiscal impasse originated from the need to eliminate the budgetary rigidities constraining a structurally sustainable balanced budget; the high transaction costs involved in promoting fiscal reform and getting it approved by Congress demanded substantive coordinating and aggregating capacity from the state. The political impasse derived from an inadequate institutional
legacy, which prevented the conditions of
governability of the political system. Constitu-
tional reform was needed, and it required the same
state capacities.

One other important question relates to how
to characterize the game of conflicts underlying
fiscal reform in Brazil. Back in the mid-1970s or
early 1980s this game seemed more typically zero
sum; that is, the task faced by the state was that of
shifting resources, or redistributing costs by shift-
ing the configuration of winners and losers. The
failure of the state to act then suggests the lack of
capacity to arbitrate the dispute, or indicates that
the state was captured by the stalemate of the con-
flict. As the economic situation deteriorated in the
1980s, the dispute over shrinking resources ac-
quired another dimension as it became distinc-
tively predatory. The number of gainers from the
status quo diminished, approaching a negative sum
game where every player would compromise its
future, unless the means for cooperation could be
found. By then, governance capacity had reached
dangerously low levels. The state seemed unable
to perform one of the prime functions of its con-
stitutive mandate, that of guaranteeing the mini-
mal institutional conditions for economic inter-
actions to take place in society.

This is exactly when the adjustment opportu-
nity becomes at the same time more meaningful
and more plausible. Crises can be great engines
of change, because they disrupt established pat-
terns and may dislodge ingrained perceptions, as
well as power and income. Nevertheless, there are
no certainties, no predetermined paths out of cri-
es; indeed, crises are nothing but contingencies,
which can involve further deterioration as well as
potential improvements. Thus, the burden of turn-
ing crises into positive, or growth-enhancing con-
tingencies ultimately rests with political manage-
ment and capacity.

Yet how does one exit the negative sum game
in a context of a shortage of state capacity? The
idea of visions, or of national projects that can
meaningfully picture the future in a more encom-
passing way than the immediate goals of economic
reform, may be critical. Visions can interfere with
the intertemporality of the tradeoff by projecting
the long-term view, where benefits are more in-
clusive, rather than the short-term picture, where
the inequality of these benefits is more divisive.
Visions can also portray the reform as indivisible
in that sense, as well preempting the conflict likely
to arise over the differential impact of the policy
components of reform on the various segments of
the society. Finally, visions can endow states with
increased capacity, because the focus on long-
term, broad goals will identify the state with the
promotion of what Olson calls encompassing,
rather than narrow, interests.

Brazil had been home to a powerful national
project in the past, which centered on the goal of
self-sufficient industrial capacity and was event-
ually supported by a set of economic policies as-
associated with an import-substitution development
strategy. But the idea of a strong national indus-
try preceded these policies; it even preceded the
development of significant national industry. It
was in the name of the promotion of this idea that
the previously hegemonic agrarian oligarchies
were displaced from the control of government.
Such a project may never have developed into a
full-fledged vision, but it formed a powerful iden-
tity for the country, galvanizing its energy and
support for the industrialization effort, and con-
vincingly associating this effort with the values
of national sovereignty and modernization.

The project of industrial self-sufficiency,
tinged with autarchic overtones, but chronically
dependent for its promotion on the foreign ex-
change brought in initially by agricultural exports,
and later by external investments and loans, was
always more consistent politically than economi-
cally. It was also as a political rather than an eco-
omic project that it proved to be more resilient
and enduring. Well after it had clearly ceased to
deliver economic benefits to society, it continued
to command strong ideological support. It can be
argued that by then the import substitution poli-
cies had generated powerful clients dependent on their rents who would resist their demise, quite irrespective of their impact on welfare.

Import substitution policies implied substantial transference of income across population groups and sectors of the economy. Nevertheless, the intrinsic merits of these policies, or the plausible counterfactual that a similar growth performance could have been obtained with less distortion through a more balanced reliance on market mechanisms, is of less concern here than the endorsement of national industrialization, which was seen as belonging to the country as a whole. As such, it provided a shared set of values and goals that the population could understand and embrace, rendering more meaningful each social group’s participation in the country’s economy. Yet even more significantly, the articulation and promotion of this project endowed the state with a reasonable degree of autonomy for several decades at least, empowering it to introduce sweeping changes in the country and alter the overall direction of policies away from the explicit interests of the most powerful economic groups.

The national industrialization project died unattended in the 1980s, and the state made no effort to either adapt or replace it. The vision vacuum, or the conspicuous absence of any overall rationale for governmental policy performance, continued beyond the lost decade. Even as the state strived to regroup its political capacity in the early 1990s, it showed a clear reluctance to associate its policies with grand ideas or overarching projects. Except for the affirmed commitment to poverty alleviation and enhanced educational opportunities, most of the economic policies that consumed the government’s energy were presented in the form of a negative agenda; that is, it consisted mainly of exposing the distortions of the previous policies and related institutional arrangements that the government wanted to alter or reverse.

The government’s reluctance to commit itself to longer-term, broad-based projects for the nation’s future was reflected by the president’s repeated insistence that he favored showing policy results rather than making promises. Yet this favored approach was giving way to basic communication gaps, rendering many of the government’s policies unintelligible, particularly policies that faced trouble in delivering results. Most of the country’s population did not need any help in understanding or appreciating the achievements of the Real Plan in curbing inflation; it returned the favor with the support that brought Cardoso to the presidency. But as far as most of the country was concerned, stabilization was a done deal; the intricacies of fiscal policy and its pivotal role in sustaining economic adjustment were not readily accessible. Just as the initial popular elation with the much lower inflation rates receded, some of the costs of the Real Plan became simultaneously more visible and less comprehensible, particularly those affecting primarily the middle class, such as the hikes in interest rates and general prices in the services sectors.

Short of vision creation, a clear articulation of the positive goals of reform, the roadmap that could lead from stabilization to social justice and sustained economic development, and the nature of the obstacles in their way could help generate stronger and more active support for the government. Such support could be critical for a government attempting to introduce sweeping institutional changes in the context of fragmented state resources; it could help empower the government to rescue a larger margin of maneuverability from the interests lodged within the state apparatus.

Capture and vision share a strong conceptual affinity; the latter can help provide states an exit from the former. Visions are power-generating mechanisms that are not intrinsically any more manipulative than politics itself; indeed, they can fulfill the important institutional function of providing a bonding language of shared values to society. But vision creation is always a daring enterprise, seemingly not very attractive to the
contemporary breed of cautious, risk-averse, re-
form leaders. As Brazil has demonstrated so far, 
many reform experiences will likely proceed 
without the support of visions. Sustaining the 
course of reform, however, may not be possi-
ble if governments discount the importance of 
two-way political communication. Unless society 
is actively engaged in the process of institutional 
changes, proreform governments run a high risk 
of progressively alienating society from the 
reform process, ultimately rendering it politically 
unfeasible.
### Appendix

#### Brazilian Adjustment Plans, 1979–91

<table>
<thead>
<tr>
<th>Diagnosis of disequilibria</th>
<th>Nature of economic measures</th>
<th>Effects of economic measures</th>
</tr>
</thead>
</table>
| **Delfim Netto’s 1979 plan** | • Hybrid expansionist program  
• 30% maxidevaluation  
• Establishment, on an ex-ante basis, of the levels of indexation and exchange rate devaluation  
• Control of domestic credit expansion  
• Policy providing real gains for lower wages  
• Tightening of import controls | • Inflation (IGP/FGV) increases from yearly rate of 76.8% in 1979 to 110.2% in 1980  
• GDP growth: 6.4% in 1979 and 7.2% in 1980  
• Industrial production growth: 6.4% in 1969 and 7.9% in 1980  
• Trade balance: US$2.8 billion in 1979 and US$2.8 billion in 1980  
• Deepened economic imbalance; country more vulnerable to external shocks |
| Financial imbalance and accommodating monetary policy drove inflation and external deficits | • Increase in real interest rates; mini-devaluations kept at an accelerated pace  
• Price liberalization for some industrial sectors  
• Limitation of SOE expenditures (current, capital, and imports) and loans (internal and external); SOEs submitted to strict control  
• Enhanced fiscal incentives for industrial exports | • Inflation (IGP/FGV) at 95.2% in 1981 and 99.7% in 1982  
• GDP growth: 1.6% in 1981 and 0.9% in 1982  
• Trade balance: US$1.2 billion in 1981 and US$0.78 billion in 1982  
• Industrial production growth: −5.5% in 1981 and 0.6% in 1982 |
| **Delfim Netto’s 1981 plan** | | |
| **Same diagnosis as 1981 plan** | • Orthodox plan monitored by the IMF with balance of payments and inflation targets  
• Contraction of government expenditures  
• Exchange rate devaluations above inflation rates  
• Cuts in SOE expenditures  
• Targets for balance of payments and inflation | • Inflation (IGP/FGV) doubled from 99.7% in 1982 to 211% in 1983  
• Plan was successful in attaining targets for external accounts and for controlling expansion of external debt  
• GDP growth: −3.2% in 1983 and 4.5% in 1984  
• Trade balance: US$6.5 billion in 1983 and US$13.1 billion in 1984  
• Industrial production growth: −6.8% in 1983 and 6.0% in 1984 |
| **Delfim Netto’s 1983 plan** | | |
| **Cruzado Plan, 1986** | • Deindexation; monetary reform, creation of the “cruzado”  
• “Tablita” for conversion of contracts  
• Salary bonus of 8%; wage, rent freeze; National Housing System mortgage payments and school fees freeze, based on previous six-month average  
• Prices frozen for indeterminate time  
• Fixed exchange rate  
• No specific rules and targets for monetary and fiscal policies | • Monthly inflation (IPC) drops from 16.2% in January 1986 to −0.11% in March, remains at low levels for three months, but reached 26.1% by June 1987  
• 8.2% GDP growth in 1986  
• 12.1% industrial growth in 1986  
• US$8.3 billion trade balance in 1986  
• Overheating: supply/demand imbalances in many sectors  
• Progressive deterioration of external accounts |
### Diagnosis of Disequilibria

**Bresser Plan, 1987**  
Inertia, and external and internal public debt burdens, driving inflation and external imbalance

<table>
<thead>
<tr>
<th>Nature of Economic Measures</th>
<th>Effects of Economic Measures</th>
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<tbody>
<tr>
<td>· Temporary freeze of prices and wages, and institution of new index (URP-Price Reference Unit) for price and wages adjustment</td>
<td>· Inflation (IPC) drops from 26.1% in June 1987 to 3.05% in July, but gradually escalated to 14.1% in December</td>
</tr>
<tr>
<td>· Announcement of active monetary and fiscal policies, unification of monetary and fiscal budgets</td>
<td>· GDP growth: 3.5% in 1987</td>
</tr>
<tr>
<td>· Real increases in public prices</td>
<td>· Industrial production growth: 0.7% in 1987</td>
</tr>
<tr>
<td>· Devaluation of “cruzeiro” (9.5%); mini-devaluations kept at an accelerated pace</td>
<td>· Trade balance: US$11.2 billion in 1987</td>
</tr>
</tbody>
</table>

**“Summer” Plan (Mailson & Nobrega), 1989**  
· Inflation driven by aggregate demand, including excessive public expenditures, indication mechanisms prevented contraction of inflation  
· Other structural causes of inflation recognized

<table>
<thead>
<tr>
<th>Nature of Economic Measures</th>
<th>Effects of Economic Measures</th>
</tr>
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<tbody>
<tr>
<td>· Hybrid program including orthodox and heterodox elements, with emphasis on graduation</td>
<td>· Inflation (IPC) drops from 70.3% in January 1989 to 3.6% in February; remains below 10% until May 1989; expands back to 24.8% in June and accelerated afterwards</td>
</tr>
<tr>
<td>· Monetary reform; creation of “new cruzeiro”; formal deindexation of economy</td>
<td>· GDP growth: 3.3% in 1989</td>
</tr>
<tr>
<td>· “Tables” for conversion of contracts</td>
<td>· Industrial production growth: 3.2% in 1989</td>
</tr>
<tr>
<td>· Prices, wages, and exchange rate frozen</td>
<td>· Trade balance: US$16.1 billion in 1989</td>
</tr>
<tr>
<td>· Government expenditures led to availability of resources; public sector wages limited to 65% of net government revenues</td>
<td>· Failure of plan is primarily attributed to lack of reduction of government deficit and to passive and permissive bureaucracy policy</td>
</tr>
<tr>
<td>· Increase of public and administered prices</td>
<td></td>
</tr>
<tr>
<td>· Control of credit to private sector</td>
<td></td>
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<td>· Real exchange rate devaluation</td>
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</tbody>
</table>

**Collor Plan, 1990**  
· Structural obstacles leading to disequilibria and distortions in public and external sectors and in financial system  
· Policy aimed at reducing liquidity of system and permanently reducing inflation did not work

<table>
<thead>
<tr>
<th>Nature of Economic Measures</th>
<th>Effects of Economic Measures</th>
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<tr>
<td>· Hybrid program</td>
<td>· Inflation (IGP) drops from 81.3% in March 1991 to 9% in May/June; accelerated thereafter</td>
</tr>
<tr>
<td>· Temporary seizure of 80% of country’s financial assets</td>
<td>· GDP growth: -4.0% in 1990</td>
</tr>
<tr>
<td>· Introduction of floating exchange rate</td>
<td>· Industrial production growth: -8.9% in 1990</td>
</tr>
<tr>
<td>· Monetary reform, creation of the “cruzeiro”</td>
<td>· Trade balance: US$11.0 billion in 1990</td>
</tr>
<tr>
<td>· Reduction of internal and external public debt service</td>
<td>· Government unable to keep seized funds long enough; forced to expand monetary base</td>
</tr>
<tr>
<td>· Creation of new taxes, as the IOF on financial assets, and increase of existing ones; control of tax evasion</td>
<td>· Fiscal imbalance remains</td>
</tr>
<tr>
<td>· Public prices adjustment</td>
<td>· Central Bank failed to restrain monetary expansion</td>
</tr>
<tr>
<td>· Temporary freeze of prices and wages, followed by ex-ante indexation; wage policy emphasizing negotiations without government interference</td>
<td></td>
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<tr>
<td>· Administrative reform</td>
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<tr>
<td>Diagnosis of disequilibria</td>
<td>Nature of economic measures</td>
</tr>
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<td>----------------------------</td>
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<tr>
<td><strong>Collor Plan II, 1991</strong></td>
<td>• Economywide deindexation</td>
</tr>
<tr>
<td>Similar diagnosis with emphasis on microeconomic rigidities</td>
<td>• Price and wage freeze</td>
</tr>
<tr>
<td></td>
<td>• Public prices adjustment</td>
</tr>
<tr>
<td></td>
<td>• Efforts to lengthen the maturity of the public debt</td>
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<td>• Trade and capital accounts liberalization</td>
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<th><strong>Real Plan</strong></th>
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<tbody>
<tr>
<td>• Fiscal imbalances and accommodating monetary policy as root causes of inflation</td>
</tr>
<tr>
<td>• Indexation perpetuated inflationary process</td>
</tr>
<tr>
<td>• Monetary reform with introduction of monetary unit (Real) pegged to the U.S. dollar within a narrow band</td>
</tr>
<tr>
<td>• Progressive deindexation</td>
</tr>
<tr>
<td>• Trade liberalization as an instrument of competition and price stability</td>
</tr>
<tr>
<td>• Increasingly tight monetary policy</td>
</tr>
<tr>
<td>• Partial fiscal adjustment</td>
</tr>
<tr>
<td>• Inflation (INPC) drops from 48.2% on the eve of the Real—June 1994—to 1.85% in August 1994; one year later it is hovering in the range of 2–3% a month</td>
</tr>
<tr>
<td>• GDP growth accelerates: 3rd Q94: 4.5%; 4th Q94: 5.7%; 1st Q95: 6.7%</td>
</tr>
<tr>
<td>• Growing trade imbalance; trade deficit 1st Q95-2.3 b, a 82.5% increase in 1 year.</td>
</tr>
<tr>
<td>• Fiscal imbalance and exchange rate overvaluation remain major issues</td>
</tr>
</tbody>
</table>

*Source: Author's elaboration.*
Bibliography


## Abbreviations and Acronyms

All but the most generally used abbreviations and acronyms have been listed by chapter.

### General Abbreviations and Acronyms

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>BN</td>
<td>National Front</td>
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<tr>
<td>CHOGM</td>
<td>Commonwealth Heads of Government Meeting</td>
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<tr>
<td>CUEPACS</td>
<td>Congress of Unions of Employees in the Public and Civil Services</td>
</tr>
<tr>
<td>DAP</td>
<td>Democratic Action Party</td>
</tr>
<tr>
<td>EOI</td>
<td>export-oriented industrialization</td>
</tr>
<tr>
<td>EFF</td>
<td>Extended Fund Facility</td>
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<tr>
<td>ESAF</td>
<td>Extended Structural Adjustment Facility</td>
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<tr>
<td>FTZ</td>
<td>free trade zone</td>
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<tr>
<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<tr>
<td>GNP</td>
<td>gross national product</td>
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<tr>
<td>GSP</td>
<td>Generalized System of Preferences</td>
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<tr>
<td>GST</td>
<td>general sales tax</td>
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<td>HDI</td>
<td>human development index</td>
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<tr>
<td>HDR</td>
<td>Human Development Report</td>
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<tr>
<td>IDA</td>
<td>International Development Association</td>
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<tr>
<td>IDB</td>
<td>Inter-American Development Bank</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>LNG</td>
<td>liquefied natural gas</td>
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<tr>
<td>MDP</td>
<td>U.N. Management Development Program</td>
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<tr>
<td>Natcap</td>
<td>U.N. National Capacity Assessment</td>
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<tr>
<td>NFPS</td>
<td>nonfinancial public sector</td>
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<tr>
<td>NGO</td>
<td>nongovernmental organization</td>
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<tr>
<td>NIC</td>
<td>newly industrialized country</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<tr>
<td>OPC</td>
<td>Outline Perspective Plan</td>
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<tr>
<td>OPN</td>
<td>Open General Licence System</td>
</tr>
<tr>
<td>PNB</td>
<td>National Equity Corporation</td>
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<tr>
<td>PAS</td>
<td>Pan-Malaysian Islamic Party</td>
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<tr>
<td>PE</td>
<td>public enterprise</td>
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<tr>
<td>PEM</td>
<td>People's Council of Trust</td>
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<tr>
<td>PNS</td>
<td>People's National Symphony Orchestra</td>
</tr>
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<td>PRM</td>
<td>Malayan People's Party</td>
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<tr>
<td>SDR</td>
<td>special drawing right (of the IMF)</td>
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<tr>
<td>SEDC</td>
<td>State Economic Development Corporation</td>
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<tr>
<td>UNDP</td>
<td>United Nations Development Program</td>
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<tr>
<td>USAID</td>
<td>U.S. Agency for International Development</td>
</tr>
<tr>
<td>UMNO</td>
<td>United Malays National Organization</td>
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<tr>
<td>VAT</td>
<td>value added tax</td>
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### Economic Strategy and Structural Adjustment in Tanzania

<table>
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<th>Abbreviation</th>
<th>Full Form</th>
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</thead>
<tbody>
<tr>
<td>ADN</td>
<td>Democratic Nationalist Alliance</td>
</tr>
<tr>
<td>COPEI</td>
<td>Christian Democrats</td>
</tr>
<tr>
<td>CEPB</td>
<td>Confederation of Bolivian Private Entrepreneurs</td>
</tr>
<tr>
<td>COMIBOL</td>
<td>state-owned mining corporation</td>
</tr>
</tbody>
</table>

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Governance, Leadership, and Communication: Building Constituencies for Economic Reform

ESF  Emergency Social Fund
IFI  international financial institution
MBL  Free Bolivia Movement
MIR  Revolutionary Leftist Movement
MNR  Revolutionary Nationalist Party
NFPS  nonfinancial public sector
NPE  New Economic Policy
SAFCO  law for the administration of public accounts
SOE  state-owned enterprise
YPFB  state-owned petroleum enterprise

Successful Adjustment and Declining Governance? The Case of Egypt

ACC  Arab Cooperation Council
ADNP  Arab Democratic Nasserite Party
ASU  Arab Socialist Union
CSF  Central Security Forces
EFLU  Egypt's Federation of Labor Unions
EOHR  Egyptian Organization for Human Rights
ERSAP  Economic and Structural Adjustment Package
IA  Islamic Alternative
INP  Institute of National Planning
JI  Jama'a Islamiya
LP  Liberal Party
LSP  Labor Socialist Party
MB  Muslim Brotherhood
MOL  Ministry of Labor
MWC  modern working class
NCEAC  Nile Company for Exporting Agricultural Crops
NDP  National Democratic Party
NMC  new middle class
NWP  New Wafd Party
ODEP  Open-Door Economic Policy
PA  professional associations
PUP  Progressive Unionist Party
PVO  private voluntary organization
RCC  Free Officers and Revolutionary Command Council
SLP  Socialist Labor Party
TWH  Takfi wal Hijra
ULP  urban lumpen proletariat

Governance and Structural Adjustment in Ghana

31 DWM  31st December Women's Movement
AGC  Ashanti Goldfields Company
CDO  Civil Defense Organization
CDR  Committee for the Defence of the Revolution
CEPS  Customs, Excise, and Preventive Services
CPP  Convention People's Party
CVC  Citizens' Vetting Committee
ERP  Economic Recovery Program
GIHOC  Ghana Industrial Holding Corporation
GPRTU  Ghana Private Road Transport Union of TUC
NDC  National Democratic Congress
NIC  National Investigation Committee
NLC  National Liberation Council
NPP  New Patriotic Party
NRC  National Redemption Council
PDC  People's Defence Committee
PNC  People's National Convention
PNDC  Provisional National Defence Council
PP  Progress Party
SAIS  Structural Adjustment Institutional Support
TUC  Trade Union Congress
WDC  Workers' Defence Committee

Governance and Fiscal Reform: A Study of Pakistan

ADBP  Agricultural Development Bank of Pakistan
APTMA  All-Pakistan Textile Manufacturers Association
CBR  Central Board of Revenue
HBFC  House Building Finance Corporation
IDBP  Industrial Development Bank of Pakistan
IJI  Islamic Jamboori Ittehad
IT0  income tax ordinance
KESC  Karachi Electricity Supply Corporation
NFC  National Finance Commission
PPP  Pakistan Peoples Party
RMTRC  Resource Mobilization and Tax Reforms Commission
SLIC  State Life Insurance Corporation
SROs  statutory rules and orders
TRC  Tax Reforms Committee
WAPDA  Water and Power Development Authority

Uneven Governance and Fiscal Failure: The Adjustment Experience in Turkey

ANAP  Anavatan Partisi (Motherland Party)
AP  Adalet Partisi (Justice Party)
ASCUS  Agricultural Sales Cooperative Unions
BTP  Buyuk Turkiye Partisi (Great Turkey Party)
CHP  Cumhuriyet Hakik Partisi (Republican People's Party)
DP  Demokrat Parti (Democratic Party)
DYP  Dogru Yol Partisi (True Path Party)
EBF  extra-budgetary fund
GNA  Grand National Assembly; Parliament
ISI  import-substituting industrialization
PSBR  public sector borrowing requirement
SEE  state economic enterprise
SHP  Sosyal Demokrat Halk Parti (Social Democratic Populist Party)
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPO</td>
<td>State Planning Organization</td>
</tr>
<tr>
<td>TUD</td>
<td>Directorate of Incentives and Implementation</td>
</tr>
<tr>
<td>BNDES</td>
<td>National Social and Economic Development Bank</td>
</tr>
<tr>
<td>COFINS</td>
<td>Corporate tax of social expenditures</td>
</tr>
<tr>
<td>FPE</td>
<td>States Participation Fund</td>
</tr>
<tr>
<td>INSS</td>
<td>National Institute of Social Security</td>
</tr>
<tr>
<td>IR</td>
<td>Income tax</td>
</tr>
<tr>
<td>IPI</td>
<td>Industrial production tax</td>
</tr>
<tr>
<td>PND</td>
<td>National Development Plan</td>
</tr>
</tbody>
</table>