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THE POLITICAL ECONOMY  
OF STABILIZATION PROGRAMMES  
IN DEVELOPING COUNTRIES

by

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Research programme on:  
Adjustment Programmes and Equitable Growth

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## RÉSUMÉ

Ce rapport examine les effets endogènes de la mise en œuvre dans les pays en développement de programmes de stabilisation (crédits et différentes formes de conditionalité). Un modèle est ébauché à partir de l'Économie politique moderne et de la Nouvelle économie des institutions, tout en tenant compte des aspects cognitifs (psychologiques) du processus de prise de décision. Mettant l'accent sur la demande et l'offre de soutien de la population et des divers groupes d'intérêt au gouvernement, ce modèle aide à expliquer non seulement les effets de tels programmes sur le niveau de vie, mais également sur l'utilisation d'instruments par les groupes concernés. En particulier, sont analysés les effets sur la consommation des élites politiques, sur l'importance de la corruption, et sur les politiques répressives à l'égard de la population et de certains groupes. Les conditions qui tendent à permettre une meilleure situation économique et/ou politique pour la population sont identifiées et un certain nombre de propositions vérifiables sont formulées.

## SUMMARY

This report investigates the endogenous effects of the implementation of stabilization programmes (credits and different variants of conditionalities) in developing countries. A model is outlined, which at the same time builds on Modern Political Economy and New Institutional Economy and incorporates cognitive (psychological) aspects in decision making. Emphasizing the demand and supply of support for the government by the various interest groups and the population, this model helps to explain not only the programmes' effects on the standard of living, but also on the use of instruments by the groups involved. Especially, effects on the politicians' own consumption, the extent of corruption by bribery and the suppression of the population and particular groups are analysed. Conditions under which the economic and/or the political situations improve for the population are identified and corresponding testable propositions are formulated.

## PREFACE

In 1990 the Development Centre began a research project on the political feasibility of adjustment programmes. This Technical Paper is part of an extension of a completed project on "Adjustment Programmes and Equitable Growth". Indeed, it is important, not only to reduce the social costs of adjustment, but also to place such programmes in their political context. Whatever the government's strategy may be, it risks running up against discontent and even violent opposition from certain groups when it applies a stabilization programme. In many countries, these reactions have led to the suspension of the programme even though to delay will be even more costly in the future because disequilibria will have worsened.

It is therefore indispensable to analyse the political conditions in which adjustment takes place, because even the most technically well conceived or the most equitable programme is of no use if it is politically unacceptable. In order to establish points of reference for our empirical studies, we asked Bruno S. Frey and Reiner Eichenberger to prepare this analysis of the political aspects of stabilization. It is a difficult task for, if there are several economic or political analyses of adjustment, there are very few which study the two aspects together. The authors have made a remarkable attempt to construct an original politico-economic model, with reference to the school of positive economy.

Assuming that the government behaves as do other groups in society, in a rational self interested way, and by studying the government's demand for support from other groups and their offer of it, this model helps in understanding government decisions during adjustment. The authors take the habitual conditionality measures and demonstrate all the possible strategies of a government which chooses to apply or not to apply specific measures, to offer compensatory measures to losing groups, to employ repression or to use propaganda. This paper offers the new and interesting concept of *attributability*: the reactions of groups do not result from the real responsibility of government, but from responsibilities which such groups attribute to governments.

This Technical Paper constitutes a very useful instrument for empirical research currently underway on the relationship between stabilisation measures and social instability, and on their management by governments, both in detailed case studies and based on samples of countries large enough to allow the application of econometric testing. In this sense, this paper represents not only a building block but the foundation stone for this later work.

Louis Emmerij  
President, OECD Development Centre  
February 1992

## I. PROBLEMS AND ISSUES

### Setting the Stage

The governments of many developing countries are faced with severe economic problems. These problems are reflected in high and galloping rates of inflation, large shares of the population without adequate employment, and low real growth or even declining standards of living. The balance of payments and the budget are regularly in deficit. The often large and rising excess of government expenditures over revenues is mostly due to a rapid increase of subsidies for basic foodstuffs and other consumer goods and services (e.g. electricity, housing and credit) which, in its turn, leads to increasing distortions in the price system: the relative (marginal) cost of production bears little relationship to prices.

To deal with these problems, the developing countries' governments may turn to various sources of outside help. While some countries are fortunate enough to receive substantial help from industrial countries for strategic political reasons (Israel and Cuba are or were good examples of this), most governments have to resort to the international credit market, but due to the high country risk typically attributed to nations in trouble, either the interest rates are very high or credits are not available at all. Governments of countries subject to rationing on credit markets must then turn to international financial institutions, primarily the International Monetary Fund and the International Bank for Reconstruction and Development (World Bank). The cost of the credit to the government of the recipient developing country is then less (or not at all) reflected in the interest rate but rather in the conditionalities attached, i.e. in the adjustment programme the country is contractually obliged to undertake. In such programmes three kinds of action (which are partly interdependent) are normally required of the developing country's government:

- (i) currency must be devalued in order to balance external accounts;
- (ii) the budget must be balanced ; and
- (iii) the distorted price structure must be reformed, which involves, in particular, a sharp reduction or ending of subsidies to households and firms.

### Identifying the Problem

Experience shows convincingly that such adjustment programmes meet with limited or no success in three respects: (i) the economic conditions of the countries receiving the credits improve only slightly or not at all (compared to what was expected or compared to the past, see e.g. Edwards 1989, p. 25 ff.); (ii) repression of the population by their rulers in the recipient countries often increases and human and democratic rights are increasingly violated. This may



happen both with improving and with worsening economic conditions; and (iii) the conditionalities, which the recipient countries' governments formally accepted, are fulfilled to a small degree only, and many, if not most programmes, are abandoned after a relatively short period (e.g. Edwards 1989, p. 30 ff.).

## Our Contribution

In this report, we address ourselves to two issues:

- (i) A *positive analysis* of the politico-economic interrelationships involved. We identify the survival drive of the developing countries' governments as a major explanatory factor and deduce that the limited results achieved by the credits and adjustment programmes can be explained within a rational choice framework. The analysis focuses on the short term, because that is the crucial period from the politico-economic point of view. Programmes are thwarted which, in the long run, would be successful if the political and economic problems induced by the conditionalities lead to a change in policy inhibiting economic growth.
- (ii) A *normative policy analysis* in which we focus on the dependence of politico-economic outcomes on institutional conditions which, to a certain extent, are open to choice. In particular, it is hypothesised under what circumstances an adjustment programme would be more or less successful.

## Procedure

In Part II the report establishes a general framework for the analysis in which the basic interaction between the economy, the polity and the main actors (the developing countries' governments and the domestic interest groups) are specified. The scientific approach founded on Public Choice (the Economic Theory of Politics), as reflected in the model of government and other institutions, are also discussed and compared to competing approaches. Part III develops a simple interactive model in terms of the demand for and the supply of government support. Part IV focuses on two fundamental features; *attributability* and *appropriability*, which can be looked at as essential filters through which the politico-economic interaction passes. The following Part V discusses the determinants of the government's survival through the support or opposition by the various groups. Part VI introduces credits and conditionalities and deals with their effects on the outcome produced by the politico-economic system. The government's reactions to the changes brought about by a stabilization programme are discussed in Part VII. The following Part VIII interprets the new politico-economic equilibrium by discussing various scenarios based on the theoretical structure developed, and Part IX advances concluding remarks.

## II. GENERAL FRAMEWORK AND APPROACH

### 1. The Basic Relationships

The state of the economy and the resources flowing from the economy to specific groups influence the polity through their impact on the utility and survival probability of the government. The reverse causation runs from the government which seeks to influence the economy in order to improve its own welfare, and, above all, in order to remain in power.

Figure 1 represents the basic outline of this circular flow between the economy and the polity.

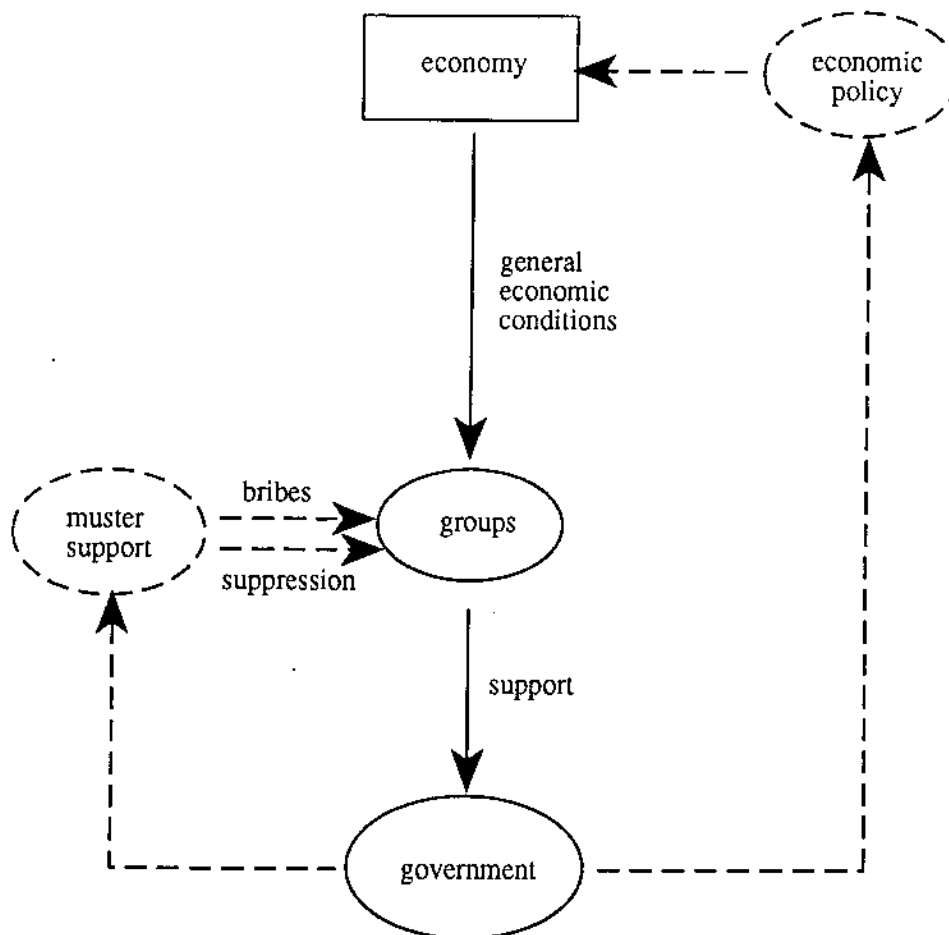


Figure 1: Politico-economic interdependence in a developing country

This figure illustrates one of the basic features of our analysis of developing countries, namely that the government is an *endogenous* element of the politico-economic relationships: its survival depends on the support (or opposition) provided by the various groups which, in turn, influences its own utility and survival by using the classical policy instruments, serving to influence the state of the

economy and the utility of the different groups, as well as by sanctioning groups by means of suppression and/or bribes in order to muster support . The possibility of imposing direct negative sanctions on opposition groups distinguishes this politico-economic model from more traditional ones, more suited to democratic countries.

This outline of the basic features of the politico-economic model makes clear that the working of the system depends crucially on the *institutional conditions*. In a *classical democracy* of the type dominant in the West, the economy has an impact upon the polity because the voters are able to express their satisfaction or dissatisfaction with the state of the economy in elections. While interest groups are important, they act through the institutionalised channels of influence, of which the regular elections are by far the most important (1).

In the *authoritarian political systems* typical of developing countries, elections play a lesser role or are even non-existent. They do not necessarily determine who is in power: a government can be deposed of without electoral defeat, can come to power without having been (freely) elected or can stay in power despite an electoral defeat (like the military regime in Burma after the opposition election victory in 1990). Accordingly, groups' influence goes much further than in a democracy. In the extreme, a group such as the military, or part of it, may take over the government by force. Authoritarian systems are thus characterised by the dominant position of the government and the limited constitutional role of the citizens who therefore must put more emphasis on expressing their wishes in other ways than by free elections – such as demonstrations, strikes or uprisings. The government, in turn, resorts to all kinds of force to repress the population in general, and also specific opposition groups. For all actors, such behaviour is restricted by the means available, i.e. the resource constraints determine the government's, voters' and groups' possibility sets.

While democratic and authoritarian political systems differ fundamentally with respect to the extent of actual and potential force used, in both the governments seek to influence political outcomes by handing out, or calling back, benefits to specific groups. An important example for a democracy are the direct and indirect monetary transfers given to the farmers. Such transfers are not usually called “bribes” but the term is nevertheless used here in order to highlight its function, namely to promote the government's survival.

## **2. Government and Other Institutions**

Figure 1 demonstrates how the government plays a central role in the political economy of developing countries: it is influenced by the economic conditions and in turn affects economic conditions via its economic policy. For this reason this subsection focuses on the model of government behaviour used. The general model is also applicable to other decision makers.

The analysis undertaken here is based on methodological individualism in the form of rational choice. Following *Public Choice* analysis, governments (or

rather the politicians in power) are taken to maximise their own utility subject to constraints. The government politicians may adhere to an ideology, but also are concerned with consuming and maintaining power. Indeed, it is not only in developing countries that politicians attach considerable importance to increasing their private income and wealth. In the following, we will therefore concentrate on differences in the constraints. Three main types of constraints for the government will be discussed: political constraints, technical constraints and resource constraints.

(i) *Political Constraints*: While in the liberal democracies politicians are subject to re-election constraints, politicians in developing countries are aware that they could be overthrown by a coup d'état, an uprising or a revolution; they may provide against this threat by transferring (often large) sums to foreign countries. A government's survival depends on a sufficiently high level of support, or on a sufficiently low level of opposition, from the various groups of the society. Obviously, the groups are not equally capable of threatening the government's survival; some groups - in many developing countries in particular, the military - are essential, while others can be more easily repressed. Support or opposition by groups depends not only on the absolute level of the net benefits they receive from the government, but more on the relative level - the benefits the groups enjoy compared to those they could obtain from an alternative government. These choices therefore shape the constraints of the government. Most modelling attempts renounce an explicit endogenisation of these alternatives<sup>(2)</sup>. In this context it is interesting to distinguish between two types of credits received from an international institution:

- A pure "*government credit*" goes to the ruling government only, and not to the opposition if it came to power. The groups have therefore an incentive to support the government from which it can expect to benefit due to the additional resource inflow.
- A pure "*country credit*" goes to a country irrespective of which politicians are in power. In particular, the opposition, once in power, also expects to benefit from the additional inflow of resources. In this case, the groups' support for the government and the opposition is unaffected, or, in other words, the government's support and chance of survival do not increase.

Whether the granted credit is a "government credit" or a "country credit" is partly determined by the conditions under which it is granted, but more importantly the government's success in getting hold of the credit. This is analysed by the concept of *appropriability*.

The same aspects are also relevant on the debt side. The debt may be payable by the government while the opposition - once in power - may not be liable. In general, however, the debt is payable by the country and an opposition must honour it. Thus, the concept of *appropriability* refers to both the credit and debit side, producing four possible extreme combinations as shown in Table 1.

**Table 1:** Polar combinations of the appropriability of credits and debts

		Appropriability of credit	
		government	country
appropriability of debt	government	B	D
	country	C	A

Cell A describes the case analysed in traditional economic theory where both the credit and the debt refers to the country as a whole. Cell B shows the opposite: both credit and debt are borne by the reigning government only. This would be the case, for example, if a dictator spends all the credit and the politicians following him or her after a coup d'état refuse to honour the debt. Cell C shows the case in which the government fully appropriates all the credit, but the country as a whole, and hence the following government, has to carry the burden. Cell D shows the reverse case. Depending on which of the (polar) cases applies – on the extent of appropriability – the outcome of credits for developing countries differs with respect to economic as well as to political conditions.

In addition to these economic notions, new research in cognitive psychology indicates that the perception of benefits and cost may be systematically biased (see Frey and Eichenberger 1989b, 1991). There is powerful evidence that most people evaluate an alternative (such as government policy) not only compared to the objective alternative, but to some subjective reference point, which is very often the status quo. As Lindenberg (1989) shows, such behavioural regularities help to explain political phenomena such as revolutions. This issue will be discussed under the concept of *attributability*.

(ii) *Technical Constraints:* The government is, of course, also limited by the general economic and social conditions, as well as by the instruments available to pursue its goals. Its possibility set may be further limited by an inadequate bureaucratic structure. All these restrictions are summed up here under the term *technical constraints* but it should be borne in mind that these constraints are only partly given exogenously, as they are also influenced by the interaction between the actors involved. Thus the government's goals can be aided or hindered by the bureaucracy.

(iii) *Resource constraints:* The government has limited means at its disposal for pursuing its goals. The extent to which a government can *appropriate* resources for its own purposes is of crucial importance in understanding the politico-economic interactions. It suffices here to remark that the possibilities of taxation are often severely limited, and the government must resort to other means of financing its expenditure. In the context of international credits it will be important to determine what share of this resource inflow the government can directly or

indirectly appropriate. This, in turn, is mainly determined by the *conditionalities* imposed and observed (see Part VI).

The general framework in which government behaviour is analysed applies equally to the various *groups* distinguished. Their members are also assumed to pursue their own interests, in particular to increase their income and wealth, and are subject to similar constraints, which, in turn, are shaped by the behaviour of the government and the other groups.

In line with the *Comparative Analysis of Institutions*<sup>(3)</sup>, the behaviour of actors is explained by the differing institutional conditions they face. These conditions may vary over time or between geographical areas (time series and cross section analysis), but what matters is that the different institutions determine the constraints and hence the relative cost (prices) of alternative courses of behaviour. The actors systematically respond to these changes in relative prices by choosing those opportunities with the highest net benefits. It is thus argued that the behaviour of government cannot be explained satisfactorily unless the underlying institutional conditions are carefully taken into account. In the case of a particular developing country it is, for example, crucial to know whether regular elections exist and – at least in principle – as a consequence, an orderly change of government according to preset institutional rules is possible (as in Brazil or Argentina currently) or whether “elections” are only used as a manifestation of support for whatever government is in power.

Institutions are seen here as social regularities which are given in the short term for a particular actor. This means (i) that an actor's behaviour is predictable to a certain extent once the relevant institutional conditions are known, and (ii) that the possibility of influencing an actor's behaviour within given institutions is very limited. Thus, for example, it makes little sense to ask a government to undertake an economic policy which would severely lower the standard of living of the urban population (or of members of the army and police), if it has to act under institutional conditions in which its survival depends not on a re-election by the whole population in a specified time period, but rather on the absence of an uprising by the urban population, or of opposition by the military.

In the following, three types of systems will be distinguished: (i) decision-making systems such as the price system (markets), democracy, hierarchy or bargaining; (ii) regulatory systems : rules, conventions, laws or traditions and (iii) organisations. These are not mutually exclusive, of course; they may well be considered as different points of view from which social regularities might be looked at.

In addition to public choice and the comparative analysis of institutions, our methodology uses elements of *Cognitive Science*, in particular the results obtained by experimental psychologists and economists with respect to behavioural decision making<sup>(4)</sup>. Our analysis reveals *attributability* to be a central concept: it translates how an “objective” reality (such as income received) is evaluated and accounted for by the various actors. A rise in one's income may, for

example, be attributed solely to one's capabilities, or it may be perceived as a payment from the government (or some other actor) in return for political support. In the context of the problems analysed here, one of the important questions will be to what extent the conditionalities imposed (and the recession normally resulting therefrom), as well as possible improvements in economic conditions made possible by the credits received, are attributed to the government in power, to a former government or to the international financial institutions.

### 3. Contrast to Existing Approaches

The perspective used here differs markedly from those traditionally employed for analysing developing countries - in particular from the analysis of stabilization programmes.

- (i) Our approach differs from *traditional economic models* of developing countries which focus purely on economic factors. In those models the interaction between the economy and the polity are disregarded, and government - in so far as it is considered at all - is explicitly or implicitly assumed to pursue the common good of the population, and not to react in any systematic way to changes in its survival probability or possibilities of increasing its members' income and wealth. Traditional economic theory of developing countries, while certainly noting the importance of groups for economic events, does not consider them to be independent actors in the sense of pursuing their own utility subject to constraints. In particular, the pertinent literature does not take into account the behaviour of those groups which critically determine a government's possibility set, the military being a case in point.
- (ii) Our approach also differs significantly from the *politico-economic models* in public choice, which have almost without exception been designed for either representative or direct democracies of western, market-oriented countries<sup>(5)</sup>. While these models (rightly) disregard the suppression of certain groups by force, this plays a major role in our analysis. Accordingly, the traditional politico-economic models have assumed that governments are able to raise revenue by taxation or money creation while we focus on the various possibilities with which the government tries to get hold of a share of the resource flows (the question of appropriability). Moreover, the cognitive aspects have received relatively short shrift in the context of politico-economic models (mainly concerning the voter's myopia and the difference between general and individual economic conditions), while the question of attributability is central in our analysis.
- (iii) The *sociological* and *political science* literature on *developing countries* which looks at behaviour in terms of class and ethnic affiliation has addressed some of the aspects which are also important in our analysis. This view certainly explains important elements but it

finds it difficult or impossible to account for short- and medium-term *changes in behaviour* due to changes in incentives (which are central to the rational choice approach). If, for example, an ethnic group switches its support from the government to the opposition (because it expects to, or actually receives, more net benefits from a prospective government), such a change in behaviour can hardly be attributed to ethnic considerations (provided the government has not changed its respective policy) but rather to a benefit-cost calculation, or to the rational choice of the group concerned. Obviously, the methodological approach employed here does not contradict the one used by sociologists and political scientists, but rather supplements it by concentrating not on levels but on *changes in behaviour*<sup>(6)</sup>. This seems to us a fruitful approach for answering the questions raised when a country disturbs the politico-economic equilibrium by resorting to outside credits.



### III. A SIMPLE INTERACTIVE MODEL

Authoritarian governments (like democratic ones) depend on the support that the population and/or groups are willing to provide. It is therefore useful to model the interaction between the government and the population/groups in a demand and supply framework, wherein the government demands the support that the population/groups supply.

#### The demand for support by the government

In a politico-economic framework the two main arguments in the government's utility function ( $U_G$ ) are its own consumption ( $C$ ) and its probability of survival ( $PS$ ). Thus,  $U_G = U(C, PS)$ , with  $dU/dC \geq 0$  and  $dU/dPS \geq 0$ . As the government's survival probability is a direct function of the support it gets ( $PS = f(S)$ ,  $f' > 0$ ,  $f'' < 0$ ), we can draw Figure 2.

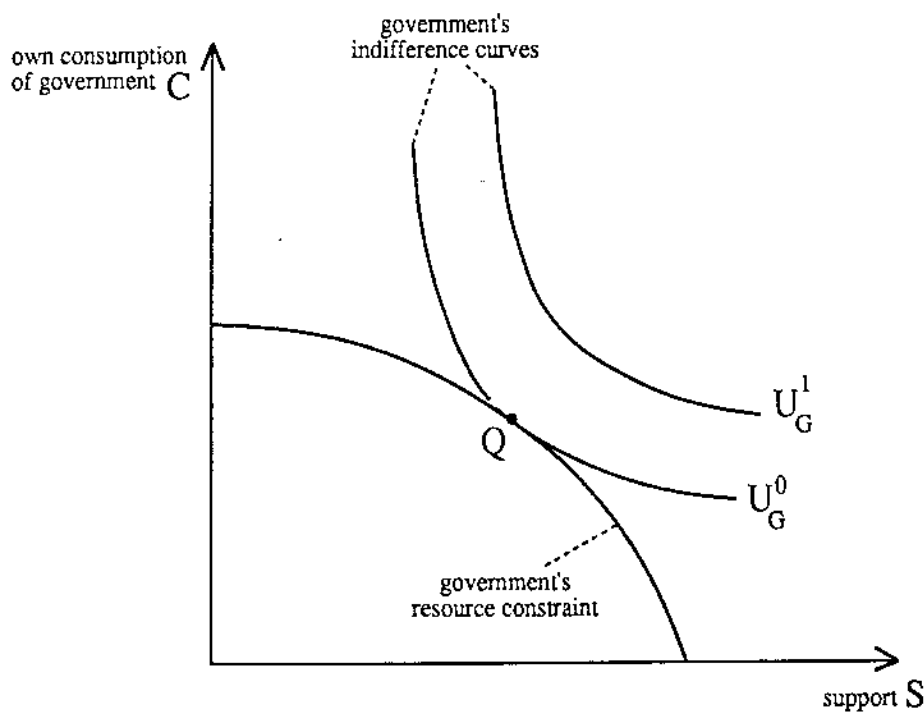
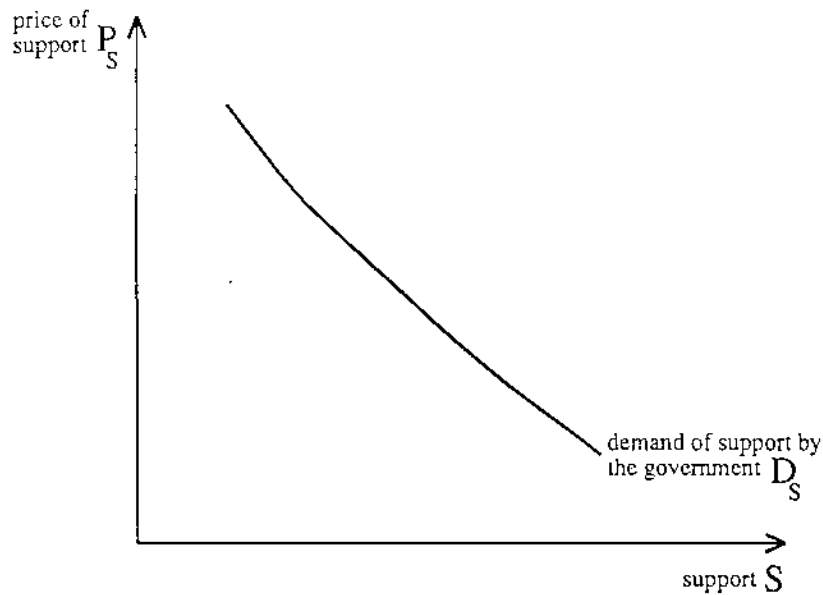


Figure 2: The government's utility

The figure shows the utility of the government in the consumption - support space and the optimum for a government that faces limited resources and a given trade-off between support and consumption. The demand for support curve (Figure 3) follows from Figure 2, if we identify the government's optimal demand for support under varying prices of support  $P_S$  (in terms of the amount of own consumption the government must give up).



**Figure 3:** Government demand for support.

### The groups' supply of support

The population and the various groups benefit from the policy of the government. According to the traditional politico-economic theory of democracy they compare the utility they get from a government with the alternatives (when the opposition parties are in power) and vote accordingly. This concept can be transferred to authoritarian systems. The necessary modifications are:

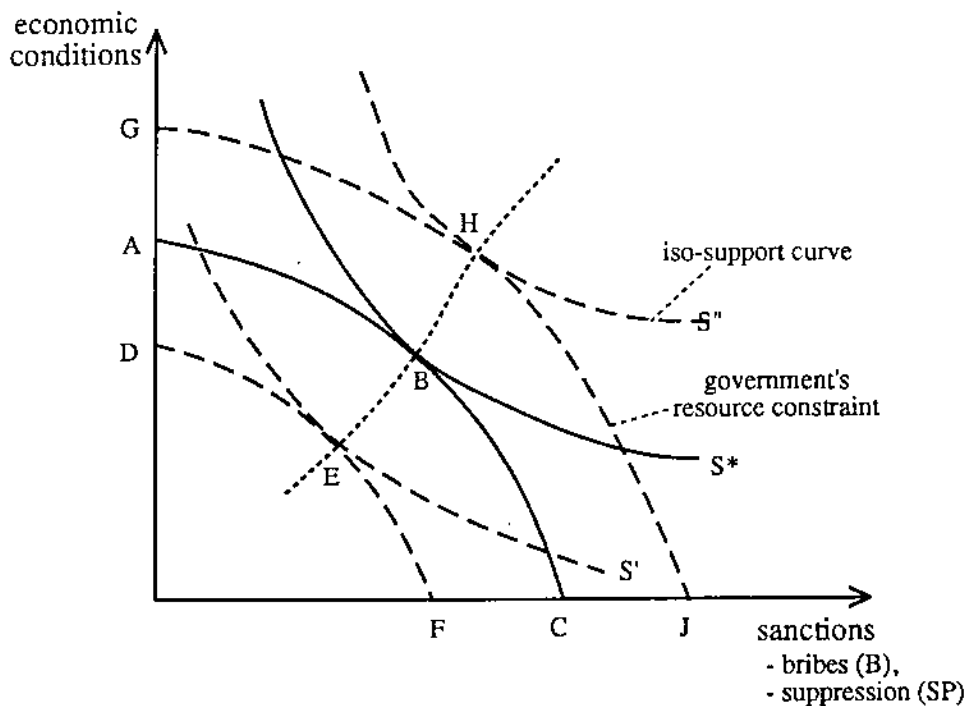
- (i) individuals cannot vote, but they can provide support and thereby increase the probability that the preferred government stays in or comes to power; and
- (ii) individuals and groups face different incentives because supporting the government or some opposition group is normally more costly than simply voting for it.

To increase its support, the government has to increase its utility to the population. For simplicity, we assume that the population/groups derive utility ( $U_P$ ) from the general economic conditions, the special privileges and the absence of negative sanctions. For that purpose, the government has three instruments: *general economic policy* (E) to improve general economic conditions; *bribing* (B) as positive sanctions; and *suppression* (SP) as negative sanctions.

The government is faced with a classical decision problem: it has to muster a sufficient amount of support from the population and the various groups in society in order to stay in power, but its possibilities, or the resources at its disposal, are limited. No government is certain to remain in power because either an organised

or a non-organised opposition always exists. The politicians (or the dictator) in power are therefore forced to use the resources available as efficiently as possible.

Figure 4 depicts this resource allocation problem for a government faced with the situation shown in Figure 1. The basic decision is how the resources should be distributed between improving general economic conditions (by making appropriate investments in infrastructure or by deregulating markets) and muzzling groups by spending resources on suppression (for the police, army or secret service), or by bribing groups to support them (by providing them with benefits through transfers, shielding them from foreign economic competition, creating rents through regulation, etc.). A trade-off obviously exists between using resources for improving general economic conditions (national income, employment, price stability) or using them to sanction the population and the different groups. This is shown by the government's possibility curve ABC. The productivity of resources to affect general economic conditions, while positive, is subject to diminishing marginal returns, and the same holds for the resources spent on groups. Consequently the possibility curve is concave with respect to the origin.



**Figure 4:** The government's decision on use of instruments

Groups respond positively to an improvement in the general economic conditions as well as to suppression and/or bribes, but the marginal utilities decrease so that the aggregate support curves by the groups (each showing a *given* level of support for the government) are convex with respect to the origin. A government which maximises its support by groups, either because it is forced to do so by the opposition or because it is risk averse, chooses point B, reaching aggregate support  $S^*$  and hence the maximum possible chance of survival.

The supply function of support for the government can be derived from Figure 4 and it corresponds to the resource constraint in Figure 2. A government less threatened by the opposition or risk-loving may choose any point inside the trade-off curve. At those points support for the government falls to a lower level but the executive can increase its own consumption, because it does not need all available resources to increase support. If it invests (DEF), it could obtain  $S'$  support in point E. If it could invest GHI resources, it could obtain  $S''$  support in point H. Combining the optimum points E, B, H we see the relationship between resources expended and support provided. The derivative of this function (Figure 5) can be interpreted as the support supply function or the marginal cost of support function which will presumably be upward-sloping.

Combining the demand function (Figure 3) and the supply function we can derive the support the government receives in the context of politico-economic interaction (see Figure 5).

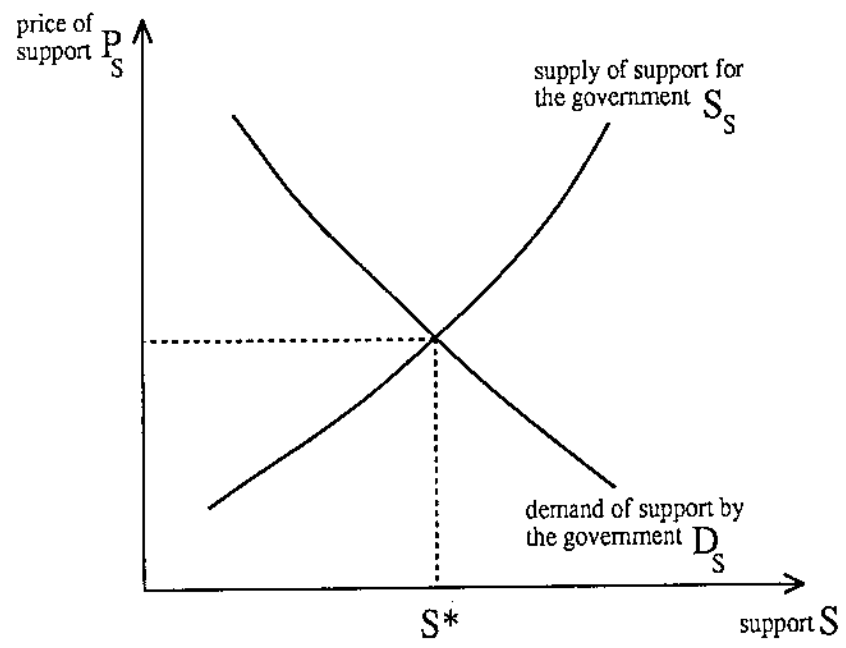


Figure 5: Equilibrium support for the government by the population and groups

**Institutional conditions determining demand for and supply of support**

The characteristics of the equilibrium between the government's demand for, and the population/groups supply of support depend on a number of factors, of which the most important for an authoritarian, developing country are discussed below.

*The government's demand for support function depends on:*

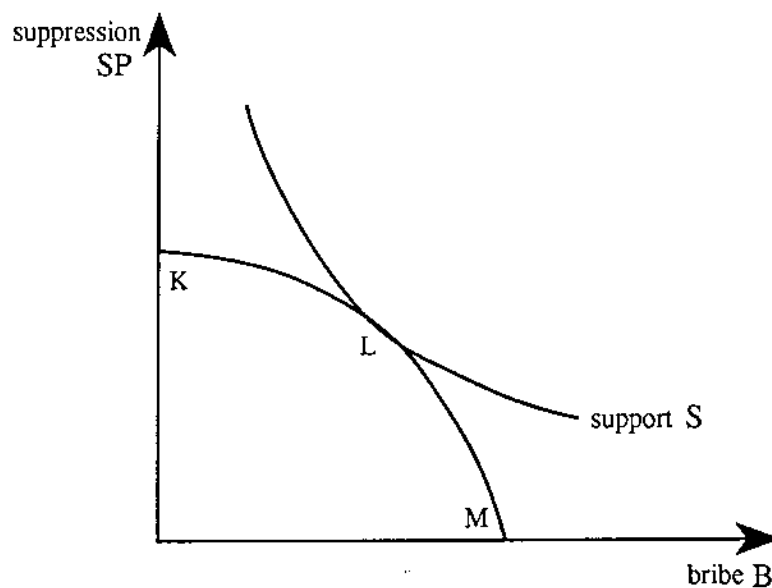
- (i) the extent to which the government can *appropriate* the resources with which it musters the groups' support. This possibility depends, among others things, on the efficiency of taxation and on the extent of public ownership of resources, and also on the conditions imposed by creditors. An increase in appropriability will shift (*ceteris paribus*) the demand curve outwards. In the new equilibrium the government enjoys a higher level of support and its chance of survival is greater. Appropriability is also crucial with respect to the consequences of a credit. The more the credit has the characteristics of a "government credit" (see section 11.2.), the more the government's demand for support function shifts outwards. The concept of *appropriability* is discussed extensively below.
- (ii) the political institutions determining the conditions under which a change of government takes place. There are great differences between a democracy – in which parties compete with each other, and the winner in regularly scheduled elections takes over the government – and a dictatorship in which the politicians in power can be removed only by a coup d'état. Two characteristics of the political system are especially important:
  - the stronger the institutional safeguards are to secure political competition between the government and opposition, the more support is needed for the government to survive. The government therefore demands a higher level of support – the demand curve shifts to the right. At the other extreme, a government which has strong institutions to safeguard its power is independent of support and has no incentive to seek it.
  - the higher the cost for government politicians of losing power (being killed, or exiled, and/or deprived of their property), the more support will be demanded – the demand function shifts to the right. This also means that government politicians who are able to move their money abroad will demand less support. This may be called the Duvalier-Marcos effect: both did not fight to the end, that is, they did not muster all the support they could have, because they had the means to live well in another country.

*The supply of support for the government function depends on:*

- (i) the economic possibilities (in particular the natural and human resources) in a country. When the resources available to the population increase, a given amount of support can be provided at lower cost. The supply of support function shifts to the right.

- (ii) the politico-economic institutions (market versus planning, extent of federalism, as well as a multitude of microeconomic conditions, such as the existence of well defined, tradable and enforceable property rights). Examples are:
- The better the population's private sector alternatives are to pursue its utility (the better defined private property rights are in private markets), the higher the opportunity cost of supporting the government is; the support function shifts to the left.
  - The more decentralised a state is, the more difficult is it for the government to use negative sanctions against the population –. the support function shifts to the left.
  - When the population's confidence that support provided today will be honoured by the government in the future increases, the supply curve shifts to the right.
- (iv) the effectiveness with which the government influences the state of the economy by its economic policy measures depends on the quality of the public administration. When the government's efficiency of influencing general economic conditions rises, it can produce more benefits for the population for a given amount of input, which shifts the supply function to the right. The same mechanism holds for positive and negative sanctions.
- (v) the extent to which an improvement or a deterioration of the general economic conditions affects the government. This report stresses that the crucial question is not so much whether general economic conditions improve or worsen, but the extent to which this is *attributed* to the government<sup>(7)</sup>. There may be cases in which the state of the economy gets better, but the groups judge this improvement to be due to external forces (an upturn in the world economy, for example, or an increase in natural resource prices), in which case the government is not (necessarily) rewarded because the groups feel that the opposition would have done equally well. The opposite case is probably even more important: the state of the economy deteriorates but the groups judge this due to external forces which neither the government in power nor the opposition could control. Examples are natural disasters, recessions in the world economy, or intervention by powerful foreign countries (the imposition of trade barriers or boycotts). In this (extreme) case the government loses little or no support from the groups (i.e. the support isoquant in Figure 4 is rather flat). Therefore, an increase in the extent to which an improvement of the economic conditions is attributed to the government shifts the supply curve outward *ceteris paribus*. The aspect of *attributability* will be discussed extensively below.

The government's optimisation problem subject to the resource constraint has been expounded here for simplicity without distinguishing between various groups. The choice made by the government (whose members are assumed to act rationally) is dominated systematically by relative prices, which in turn depend on the factors determining the government's possibility set and support curves. Any government, even a dictatorial one, is influenced by the generalised law of demand: an activity which becomes more expensive, is undertaken less in comparison to other activities. If, for instance, an improvement in economic conditions is attributed less to the government than before (the productivity of investing resources into general economic conditions falls), the politicians in power will resort more to seeking the groups' support directly by either bribing or suppressing them. As will become clear, the government may substitute the support of one group for the support of another, a decision which is also influenced by the expected return relative to the cost of suppressing and bribing one particular group compared to another. Both sanctioning activities consume resources, and the government is again faced with a trade-off, as shown in Figure 6.



**Figure 6:** Government's decision on suppression and bribes

As the resources available to the government are not completely fungible between suppression and bribes, there are diminishing marginal returns, and the possibility curve KLM is concave with respect to the origin. As the groups react less and less to either suppression or bribes, the iso-support curves are convex with respect to the origin. The government's optimal use of resources is indicated by point L, i.e. it is not reasonable for a government (not even a dictatorial one) to rely solely (point K), or even mainly, on suppressing the population (groups).

#### IV. ATTRIBUTABILITY AND APPROPRIABILITY

Figure 7 repeats the basic relationships seen in Figures 1-6, but enlarges the views by adding two additional aspects:

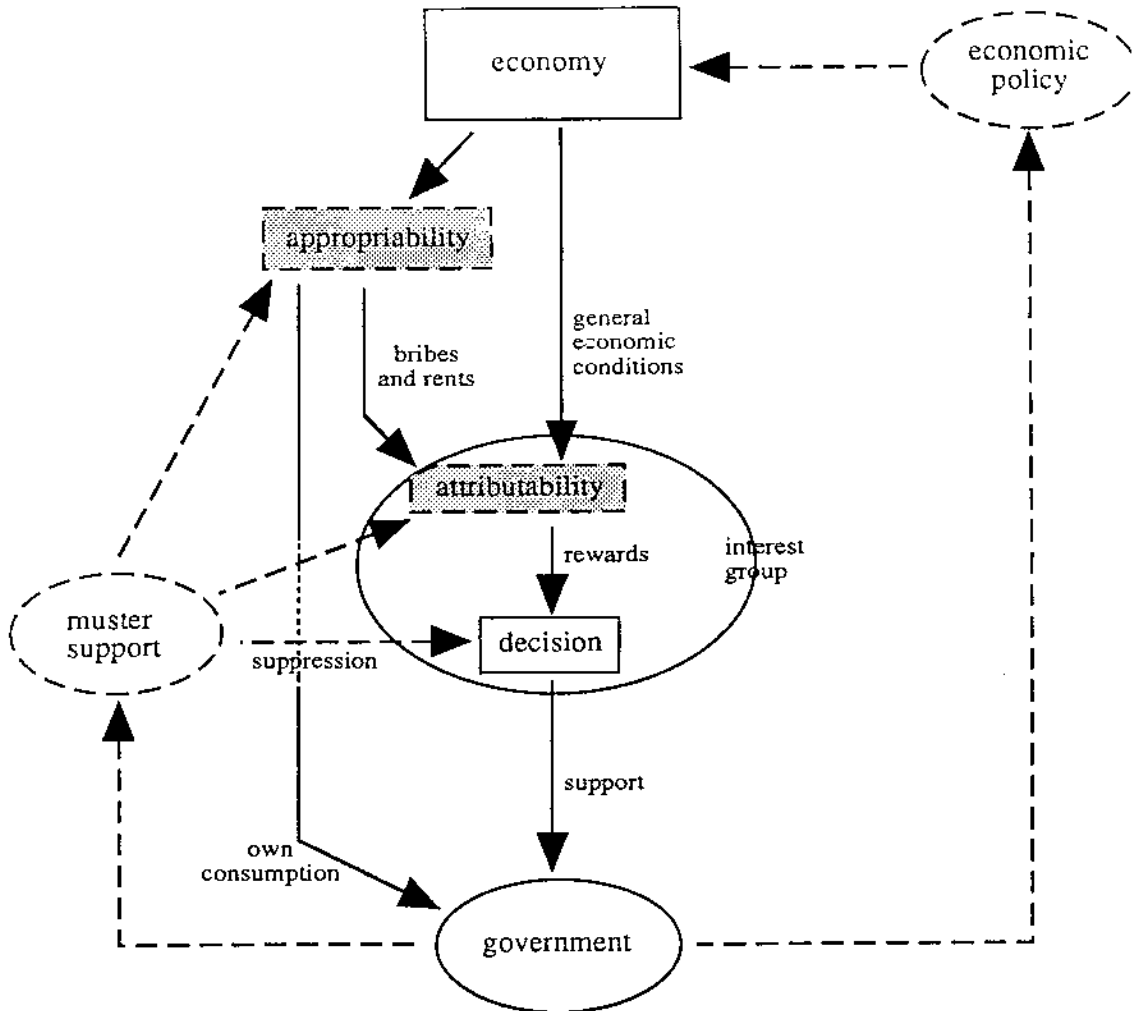


Figure 7: Appropriability and attributability

- (i) General economic conditions influence the groups through a filter for which the government is more or less strongly made accountable. *Attributability* influences the extent to which the groups feel that the existing state of the economy is due to the government, and therefore determines the amount of support given to the government. An increase in the attributability of improved economic conditions *ceteris paribus* shifts the supply curve of support for the government (Figure 5) outward.
- (ii) The groups are not only rewarded by changes in general economic conditions but also by the income flows specifically directed to them



through government intervention. *Appropriability* decides the extent to which the government can raise and distribute income flows in its favour. Therefore, an increase in appropriability *ceteris paribus* shifts the demand curve of support by the government (Figure 5) outward. What matters, however, is not what the government does for a particular group but rather how such a group accounts for these flows, i.e. the filter of attributability is again relevant. Thus a group might take an income flow from the government for granted, or, conversely, might perceive it as a reward or "price" for a "service" rendered (namely for political support for the government).

Figure 7 shows that the revenue appropriated by the government may either be used to sanction groups – by rewarding or suppressing them – or for the government's own consumption for ideologically oriented policies and/or enriching the government's members. The government then must decide what share of revenues appropriated should be allocated to increase the support by groups and thus the probability of its survival, and what share can be used for politicians' own current consumption. This is a classical investment decision as expenditures for increasing the support by groups makes it possible to increase its members' wealth in the future. Moreover, as the figure indicates, the government is able to affect attributability to some extent, thereby influencing the political effectiveness of the income flows directed at particular groups. The two crucial aspects of attributability and appropriability will now be discussed in turn.

## 1. Attributability

Governments which obtain credits from international monetary institutions usually have to face a short-term worsening in general economic conditions caused by the conditionalities they have to meet. In particular, the need to balance the budget results in a recession hitting various groups in the population. Due to this, the standard of living falls, support for the government declines and opposition rises, not rarely manifesting itself in the form of demonstrations, strikes and uprisings. The extent to which the government is held accountable for the worsening economic conditions depends on four conditions:

- (i) The government in power is held to be less responsible for the economic crisis if it is able to convince the groups that it has been caused by the *former government*. This is the more easily possible, the more apparent the distinction is between the present and former government. Even if the present government is forced to undertake a stabilization programme, it can, at least to a certain extent, still attribute the negative consequences to its predecessor provided it disassociates itself clearly from the previous government. The same holds for the cost of paying back and servicing debt, which can partly be attributed to the former government.

- (ii) The present government can attribute the cost of undertaking the stabilization programme to *foreign forces* which are presented as being exogenous. The easier it is to identify the foreign events, that is the foreign scapegoat must be credible to the population and particular groups, the easier it is to reduce attributability. Blame can be attributed to foreign events such as oil price increases, wars and boycotts, the international economic situation, or the terms of trade. On the other hand, a government which claims to be in control of everything is correspondingly less able to attribute the cost of stabilization programmes to foreign causes. Thus, for example, a government which is in complete control of the capital market must also take the blame for restricting credit.
- (iii) The lower the *expectations* are, the less the government undertaking the restrictive measures is politically burdened. This effect has been empirically shown to hold for industrial democracies but is certain to hold for developing countries as well. A government's popularity with the voters depends on deviations from the longer term economic trend which shapes expectations (e.g. Frey and Schneider 1978a, 1978b, or Schneider and Frey 1988), and there is also evidence of asymmetric reactions to economic fluctuations due to a different adjustment of expectations; a government is held to be more responsible for economic deterioration than for an improvement in economic conditions.
- (iv) The population and groups may distinguish between *general economic conditions*, which they largely attribute to the government, and *own economic conditions* for which the government is considered less responsible (see Kinder and Kiewiet 1979, 1981 and Nannestad and Paldam 1991). It is therefore especially troubling for a government when losses due to economic policy hit the members of a group or even diverse groups simultaneously; people could realise that the losses are not due to their own behaviour or to bad luck. The more diffuse the effects of a stabilization programme are and the less concentrated the losing groups are, the less the concept of "general" economic conditions is relevant, and the better are the government's chances that the negative consequences of conditionalities are not attributed to it.

As has been pointed out, the attributability filter is also relevant for the income flows appropriated by the government and directed to specific groups. Wanting to survive, every government, of course, has an interest in making clear to the recipients that they owe this income to the government, and that they risk losing it if they were to reduce their political support for the government. The extent to which this is possible depends on the specific circumstances.

## 2. Appropriability

The ability of a government to raise resources and use them for its own purpose (to raise its utility and/or to improve the chances of staying in power) depends on the following conditions:

- (i) The developing country's *economic structure*. It can be hypothesised that the government is the more easily able to appropriate such resources,
  - the more closed an economy is, because firms and individuals then find it more difficult to move the resources under their control beyond the reach of their (home) government;
  - the more difficult it is to extract the natural resources (such as oil) in the country;
  - the fewer possibilities there are to switch economic activities into the shadow economy (where the resources are, by definition, beyond the reach of government);
  - the larger is the share of the economy controlled by the state that is not left to the price system. This enables the government to appropriate resources by allocating jobs, creating contracts favourable to specific groups, granting licences or foreign exchange dealings, and subsidising goods and services by selling them below cost. More generally, the larger the state-controlled sector of the economy, the more easily the government can raise revenue and allocate rents to supporting groups;
  - the better developed is the system of taxation and the more efficient is the tax bureaucracy. In many developing countries, however, the government is forced to raise revenue by means with high transaction costs and particularly strong negative side-effects for the economy such as the taxation of goods for export.
- (ii) The developing country's *political and legal structure*. A government finds it the easier to appropriate resources for its own use,
  - the less powerful the groups are from which the resources are taken. A group wields less influence, the less centralised its members, interests are, and the less they are bound by ethnic bonds and tradition;
  - the less political competition there is, i.e. the fewer institutional possibilities there are for an opposition to act in a politically effective way. The government can more easily appropriate resources in a strong dictatorship, for example, where no opposing views may be voiced, than in a politically more open system with regular elections;

- the more flexible employment is in the governmental bureaucracy, that is the fewer positions with life-tenure;
- the more developed are the organisations which exploit the difference between the artificially lowered prices paid for domestic goods and the (higher) world market price. In many African countries, government appropriation of revenue is facilitated by marketing boards which pay low prices for domestic agricultural products and export them at considerable profit (see, extensively Bates 1988b, p. 335, Nelson 1988, p. 111).

### **3. Empirical Relevance**

The purpose of this part of the report has been to show that attributability and appropriability form essential elements in the politico-economic life of developing countries. Both concepts are, in principle, amenable to empirical testing. Examples have demonstrated the empirical relevance of the two concepts. Moreover, it has been suggested that the extent of attributability, as well as of appropriability, depends on empirically observable conditions. Provided reliable data are available, it is possible to test the propositions advanced by time series and/or cross section analyses.

The politico-economic systems of developing countries, as illustrated in Figure 7, produce certain outcomes in terms of the utility and chance of survival for the government. Part V deals more extensively with the role of the various groups in these systems.

## V. GROUPS AND GOVERNMENT

### 1. Forms of Support and Opposition

Support for a government or for the opposition can be expressed in different ways depending on the institutional conditions (see Hirschman 1970, Frey 1991):

- In democracies, conventional political participation primarily involves elections. As has already been stated, elections are much less important in the large majority of developing countries, where democratic institutions are weak or non-existent.
- The administration may support or block efforts by the government to undertake some policies.
- Economic (monetary) resources can be employed to support or oppose the government, for example, by influencing the media (when they are not completely controlled by the government), or by bribing the administration and political decision makers.
- Protest may be expressed by peaceful demonstrations or politically motivated strikes, by spontaneous riots, organised boycotts, uprisings, coups d'état or terrorist activities such as guerrilla warfare.
- Finally, dissatisfied individuals or firms may exit to the domestic shadow economy or to a foreign country. The same is true of financial capital.

What particular kinds of support or opposition are used by a group depends on a benefit cost evaluation by the respective actors. The relative cost (prices) involved depend in turn on the institutional framework.

### 2. Types of Groups

The particular groups singled out in the present analysis are determined by the problem specified at the outset. Only the most important and typical groups will be distinguished, those which play a major role in a developing country's politico-economic system faced with an inflow of new foreign credits and the accompanying conditionalities.

(i) *Informed Groups*: In a developing country it is useful to differentiate between the *urban dwellers* (of poor and middle class) and the *rural agricultural workers* (subsistence farmers). The former seek to influence the government mainly by voting, strikes and riots, while the most important instruments of the latter are moving into the shadow economy and active or passive support of guerrillas if they exist. The relative political weight of the urban and the rural population may differ greatly from one developing country to another; in some developing countries the influence of the rural population is negligible (this applies to many South American

countries), while in others it is significant (as, for example, in some African countries).

(ii) *Organised Groups*: In practically all developing countries the *military* (army, navy, air force) and the *police* play a major role (see e.g. O'Kane 1989). They serve the government as instruments to suppress opposing groups, and the government is most likely to lose power if they are no longer supported by these groups. In order to survive, the government must keep the military and police satisfied. Its position is only secure if it can split the armed forces into competing factions (for example the army versus the air force) and play one group off against another (see Breton and Wintrobe 1986). *Public officials* who can support or boycott government measures, and effectively stage demonstrations constitute another important organised group. *Large producers* are also often organised; they can exert influence by threatening to withdraw financial contributions to the government (or opposition) and move to a foreign country.

### 3. The Behaviour of Groups

In the politico-economic framework illustrated in Figure 7, the various groups determine the government's chances of survival by the extent of their support or opposition. Their decision depends on the government's rewards or punishments. The groups are taken to be selfish rational actors (for simplicity's sake they are, in general, assumed to be homogeneous) who pursue their utility (mostly in terms of income and wealth) subject to the constraints imposed by the other actors and the environment. They behave as if they calculated the value of the existing government for their private ends, and compare it to what a government formed by a possible opposition (or, in the case of the military, by themselves) could offer. They *marginally* increase or reduce their support for the government according to their perceived net benefits (see the discussion in II. 2.). This even applies to groups who may be attached to the government for ethnic reasons: even in that case, support may vary depending on the net benefits gained, compared to those which might come from a government composed of a different ethnic group.

The extent of actual support or opposition by groups is greatly influenced by strategic considerations. There is a strong incentive to be a free rider, particularly with respect to an opposition intent on toppling the government. A group actively opposing, or even not showing sufficient support for the politicians in power, risks being punished severely. It is generally more advantageous to let other groups carry this burden, and to collaborate with the opposition only when it can confidently be expected that the existing government will lose. These considerations are, of course, subject to great uncertainty, and many "mistakes" are made if viewed *ex post*: supporting governments which lose power or opposing governments which remain in power, can sometimes have deadly consequences for groups which miscalculated. A general consequence of these strategic considerations is that while a government is firmly in power, opposition seems to be rather weak and is almost silent, but when it appears vulnerable and loses control,

there is a surge of opposition. (A case in point is the "unanimous support" of the policies undertaken by the Romanian dictator Ceaucescu while in power, and the almost equally unanimous opposition to his views and policies once he lost power.) There is strong evidence that even authoritarian governments and dictators underestimate strength of the opposition because they only receive favourable information and a positive feedback (see Kuran 1989, 1990).

The government can increase support, or (equivalently) reduce opposition, by using appropriated resources to either reward or suppress the groups it finds important, or by improving general economic conditions. Figure 8 shows "support supply functions" for two different groups (group A and group B), which react differently to the three instruments. The functions imply diminishing marginal returns of "buying" support by investing in resources, or an increasing price per unit of additional support. Thus additional support can only be obtained by directing more resources to the different groups, in bribes or by punishing them more for lack of support. In Figure 8 (see following page) it is assumed that group A in panel a is less inclined to support the government for a given price, say  $P^*$ , than group B: group A supplies support level  $S^A$ , group B supplies support level  $S^B$ . Moreover, Figure 8 assumes that group A is relatively more responsive to suppression and the state of the economy, while group B is more responsive to bribes. The figure indicates that an increase in the demand for support exerted by the government, that is an outward shift of the demand for support curve, increases the equilibrium price of support, which in turn changes the optimal way of securing support. The means for obtaining support are changed.

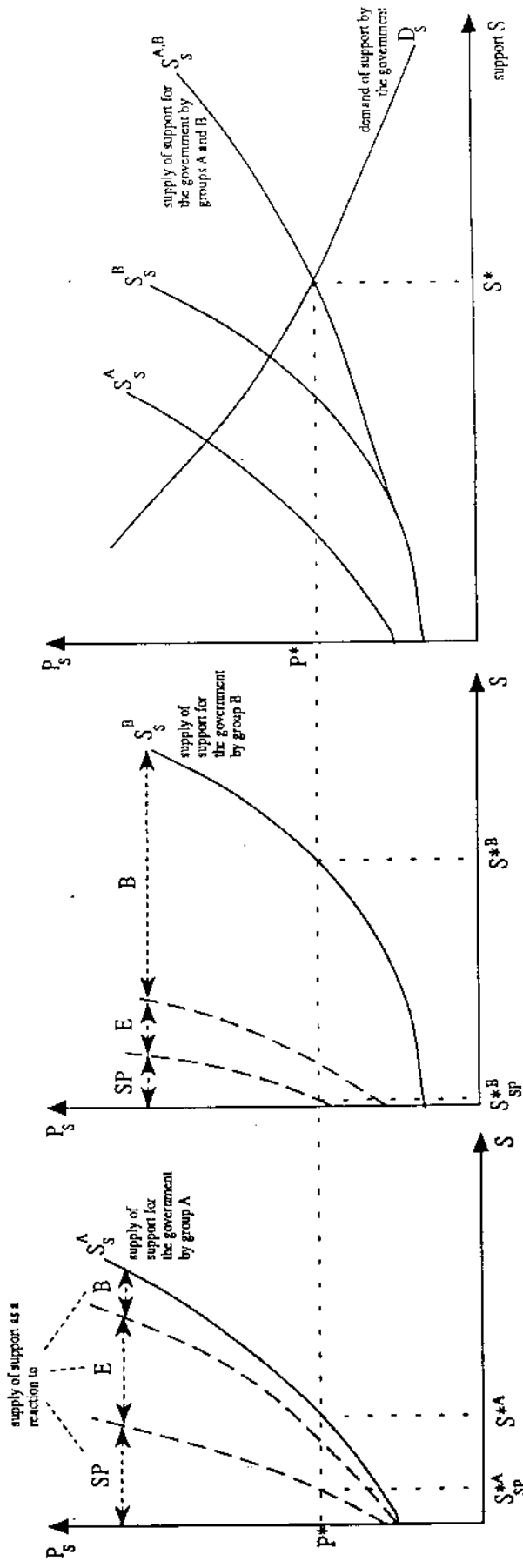
The different levels of the support function, or in terms of Figure 8 the higher price exacted for a given degree of support from group A compared to group B, can be explained by differences in institutional conditions faced by the two groups:

#### *a. Resources*

The more resources a group has, the more support it can provide and thus the various groups are of unequal importance to the government of a developing country. Therefore, the politicians in power attach differing degrees of importance to obtaining support of the various groups, or to nullifying their opposition, as the case may be. A group with little political clout (or "power") can supply limited support and is therefore of less value to the government and *ceteris paribus* fewer resources will be devoted to gaining its support or suppressing its opposition. A group's usefulness to the government depends on three major types of institutional factors:

- (i) *Political Position.* A group having a pivotal position in the formation of a winning coalition (permitting the government to survive) or the reverse, is of more value to the government than a group which does not have this "power" (in the game theoretic sense, see Riker 1962). Such a pivotal position may be occupied by various groups:

**Figure 8:** Groups' supply of support as reaction to economic conditions (E), bribes (B) and suppression (SP)



Panel a: "informal" group A

Panel b: "Organised" group B

Panel c: both groups



- In a large number of developing countries, military and police support is essential for the survival of the government. If these groups do not at least tolerate the politicians in power and refuse to carry out orders, governments are most likely to be toppled by a coup d'état, often by the military itself. The politicians in power, being aware of this danger, try to counter it by establishing a new armed group which is fully controlled by themselves. Examples are the Securitate in Ceaucescu's Romania or the Tonton Macoutes in Duvalier's Haiti, but since ancient Rome Praetorian guards have been tempted to disobey orders and to take over power themselves.
- Other groups which may be essential for the government's survival in the pivotal sense are the political and technical elites and the public bureaucracy.
- Under some rather rare circumstances the support by the (unorganised) population may also be necessary for the government's survival. The middle and lower classes of urban dwellers, in particular in the capital, may constitute an effective threat to the rulers if they are able to stage effective strikes and demonstrations. It is even more important for the government to act swiftly if such behaviour is undertaken and supported by organised trade unions. The rural population, being unorganised and dispersed, generally constitutes little threat to the politicians in power, and the government is therefore generally unwilling to spend much for their support or to reduce their opposition. The danger is higher if the rural population collaborates with a well armed and determined guerrilla movement.

According to Tullock's 1987 study *Autocracy*, most changes of government in non-democratic countries have the nature of a coup d'état by a competing group which is already part of the establishment. According to our analysis, the government attributes a large (marginal) value to such groups and *ceteris paribus* is thus willing to spend relatively large amounts of resources on rewarding or suppressing them. On the other hand, the support by the population as a whole is of relatively little value to the politicians in power and few resources will be spent on it.

- (ii) *Economic Position*. There are groups in society which are pivotal for the government's survival because they perform vital functions. Examples are government workers, such as tax or custom officials, who collect much of the state's revenue. Another group located in essential sectors may be transport workers, who assure the supply of staples for the urban population, or workers in raw materials sectors whose exports are the main source of foreign exchange. By contrast, groups which are rarely or never pivotal from the government's point of view, for example, are teachers or unskilled workers, who may protest or strike without much consequence for the government.

- (iii) *Own power base.* A group that has political and/or economic power independent of the government can better resist repression. It can, to some degree, behave strategically. Therefore, these groups typically will be bribed rather than suppressed.

#### *b. Potential for organisation*

The better a group is organised, the more efficiently it can supply support because it can better handle the free-rider problem. Therefore, the supply of support function will be the more to the right, the better the group is organised. Organisability is also important because it influences the relative effectiveness of bribe versus support: well organised groups can behave strategically. They can resist repression to some degree. Therefore, the government will be inclined to use bribes rather than suppression to obtain the support of these groups. Well organised groups are also better able to distribute bribes among their members than informal groups. This makes the use of bribes to "buy" these groups relatively efficient compared to buying informal groups with bribes.

#### *c. Available Alternatives*

The price for buying the support from a particular group is higher, the more options that group can choose from. The more viable alternatives there are to supporting the government and the more flexible a group is with respect of providing support, the more resources the government must disburse in order to win its support or reduce its opposition. The support supply curve of a specific group is therefore the more to the left the more alternatives the group has. Alternatives may be available in three respects:

- (i) The more easily the members of a group can move to an area not controlled by the government, the higher is the price for their support. This applies to a switch to the domestic private and especially to the domestic shadow economy or to foreign economies. The cost of such moves greatly differ among individuals and firms. For example, it is lower for companies with well established international contacts, and it is lower for individuals having human rather than physical, immobile capital.
- (ii) The less a group is committed to the politicians in power, the more flexible it is - which raises its support price. For instance, groups which by tradition or by ethnic or religious background are identified with the existing government, have less possibility of switching their support to the opposition because the latter is often reluctant to accept such support from a group which is (partly) responsible for the policies undertaken by the government.
- (iii) The easier it is for a group to make its voice heard, the higher is the price of its support. Control of newspapers and electronic media, and

the possession of international contacts give a group a better chance to make its position known. Speaking the same language as influential foreign nations (in particular English and French) also contributes to raising the price of support. A group with a minority language not spoken or understood outside the country, on the other hand, can have considerable difficulties in getting its views known; in this sense such a group can be condemned to supporting the government.

Another feature of the support functions is their *time variability*. Widely used positive incentives lose their effectiveness when governments are challenged. For example, material benefits lose their value when the distribution system (that is the administration) breaks down or when groups cease to believe that the government can honour its promises. Benefits can lose their value or even become negative with a change of government (e.g. orders and positions connected with the previous government). Therefore, troubled governments (with a shrinking time horizon) cannot use long-lasting, positive incentives but must resort to negative incentives which can be put into effect immediately.

The (institutional) determinants for the different levels of the support function between various groups are empirically observable. Provided the necessary data are available, the hypotheses can be tested and the relative importance of the factors to be quantitatively established.

#### **4. Induced Government Behaviour**

The government takes the groups' behaviour into account and reacts by allocating the resources at its disposal accordingly. Figure 9 (which reproduces panel C of Figure 8) illustrates the relationship between the resources used to influence the support from groups A and B, and the resulting level of support for the government. The price  $P$  paid for the support of a given group is in terms of reduced own consumption by the politicians in power. (This trade-off is explicitly illustrated in Figure 2.)

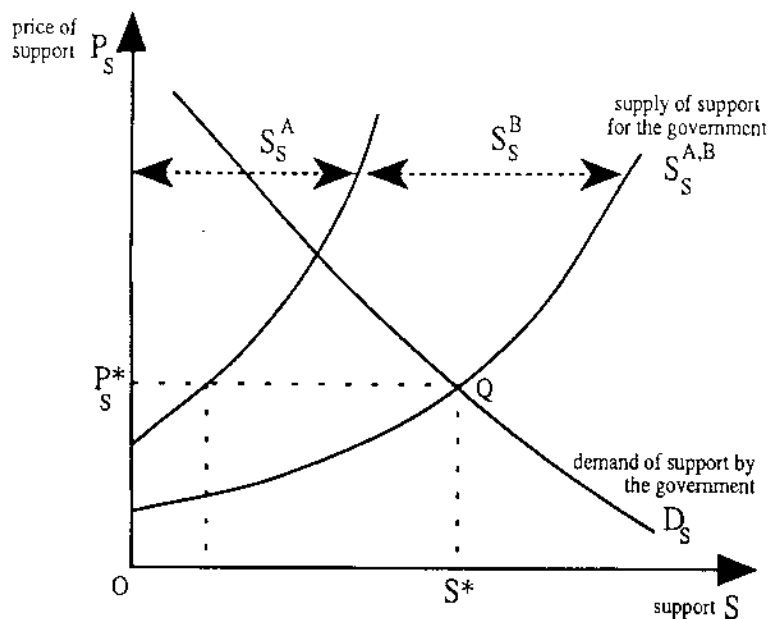


Figure 9: The government's optimal support level

The figure makes clear that the government may substitute the support of one group for support of another, keeping the support and therewith the probability of survival constant. A government acting rationally allocates the resources at its disposal by sanctioning the groups so that the marginal support effects between groups are equalized for a marginal resource unit expended. More resources for rewards or suppression will be devoted to those groups whose political position is most variable in terms of support of equal value to the government (high-price elasticity). Our theory predicts that groups whose support the government expects are not rewarded (or punished). The same holds for groups which are always expected to oppose the government. Clearly, this prediction differs from sociologically oriented analyses which predict that groups which (*ex ante*) always oppose the government must be suppressed.

A government seeking to optimise support under the restriction of limited resource appropriability takes further aspects into consideration (which are not explicitly shown in Figure 9):

- (i) Rewards as well as punishment have to be *marginal*, that is the government must be able to induce further changes in behaviour if deemed necessary. The politicians in power must take care not to reward or punish a group too much for a small change in support, because it then finds it impossible to adequately reward or punish it for additional changes in support.
- (ii) Rewards and punishments may create future expectations which thwart part of the effect. If, for instance, a group receives a transfer of income for a given amount of support, the group may grow accustomed to it and be tempted to ask more for the same "service". The government must make clear that no transfer is to be taken for granted, and it must

make clear that it is prepared to discontinue a transfer if the group does not deliver the appropriate support. This is difficult, especially as the groups receiving income flows from the government may become economically more prosperous and thus more independent which - as we have seen in section above - tends to raise the supply price of support. To reward a group for support is a two-edged sword.

Groups may also get used to repression: when they expect to be punished anyway in the future, current punishment loses much of its effect. Again, a government optimising support will make clear that a future reduction in opposition will be rewarded by a corresponding reduction in punishment.

- (iii) In the case of rewards, the government must also take care that it does not fall into the trap of rewarding a group which would, for any other reason, support it anyway. Rewards in that case may destroy the (intrinsic) motivation of supporting government, a phenomenon which in social psychology has been termed the "hidden costs of reward" (see Deci and Ryan 1985, Lepper and Greene 1978).

So far we have discussed the relationships which must be considered in modelling the politico-economic interactions in a developing country. In the next section, the problems and consequences of implementing a stabilization programme are discussed by applying the expounded modelling approach.

## VI. STABILIZATION PROGRAMME

### 1. Decision on Credits

International financial institutions like the World Bank and the International Monetary Fund offer credit at below-market interest and a more favourable repayment schedule but with a stabilization programme involving various more or less strict conditionalities. Thus a recipient developing country's government has an improved chance to overcome an economic crisis and embark on a path of economic development. The government of a developing country compares the benefits expected from the credit and its "cost" in terms of conditionalities<sup>(8)</sup> with costs on the international market where private banks supply credits. These market credits bear a higher interest rate reflecting the higher risk involved for private lenders who cannot (or at least not to the same degree as the international financial institutions) set conditionalities with respect to a stabilization programme. Often, the governments of Third World countries cannot obtain any commercial credits and they are subject to quantity restrictions (see e.g. Sachs 1990).

In equilibrium, the total cost to the recipient government for a credit of the same amount, which yields the same benefits, is equal: the higher interest in the case of market credits is the monetary equivalent of the conditionalities imposed by the international financial institutions. However, it cannot be assumed that there is such an equilibrium because large credits are rarely provided and there is a lot of room for strategic manoeuvring on both sides. Nevertheless, the availability of credits at market conditions sets an upper limit to the strictness of the conditionalities. The government of a developing country which has the option of obtaining credit on the international financial market will be under less pressure from the international financial institutions to undertake a costly stabilization programme, (especially with respect to the consequences affecting its political survival).

However, in the present analysis, the behaviour of the International Monetary Fund and the World Bank is taken to be *exogenous*. The amount of credit and the conditionalities are thus taken as given. Neither the strategic interactions between these institutions and the government (and possibly the opposition) of the recipient country, nor political decision making and bureaucratic considerations within the international financial institutions (see Frey and Schneider 1986) are considered. Our analysis is thus restricted to one side of the interaction and focuses on the developing countries receiving credit, in particular on the relationship between the government and the groups, as outlined in the previous sections.

### 2. Effects of Conditionalities on Groups

The conditionalities comprising the stabilization programmes imposed by the international financial institutions affect the various groups in a developing country in different ways. It is useful to look at the impact of the main conditionalities. They cover three major areas:

### *a. Budget Balance*

The government of the developing country is required to reduce the often huge excess of expenditure over revenues and to print less paper money, mainly to break the high or even rampant rates of inflation. This conditionality severely hurts all those groups who are net beneficiaries of the budget deficit, i.e. those who receive direct payments or transfers from the government:

- (i) the public officials (not all of whom actually work) whose compensation has to be reduced;
- (ii) the military (and the police) who have thrived on large expenditures which now have to be curtailed; and
- (iii) the urban poor (the ghetto dwellers) who receive large indirect subsidies on basic foodstuffs. Ending these subsidies causes prices to rise sharply (at least in the short term). According to an estimate for African developing countries, such staples comprise 60 to 70 per cent of the budget of the poor population, so that a price rise hits them the hardest (Bates 1988b).

The politicians wanting to stay in power are threatened by these costs of the stabilization programme falling on politically important groups.

### *b. Devaluation*

The currencies of most developing countries in economic crisis are overvalued (see Bates 1988a). The reason is that a favourable exchange rate effectively subsidises imports which are consumed by the politically important urban middle class, while the cost of this policy is born by the politically weak farmers whose products are exported and effectively taxed by the overvalued exchange rate. The devaluation under the stabilization programme hurts the middle class in the cities and particularly in the capital. This may increase the danger of a coup d'état which the government, of course, wants to prevent.

### *c. Price Reforms*

When extending credits to a developing country international financial institutions demand that the (usually) highly distorted prices in important economic sectors be corrected. In particular, the prices of highly subsidised goods or services, such as electricity, housing, domestic credit and many foods, must be raised. (At the same time, discontinuing subsidies also reduces the budget deficit, as discussed above). In the short term the higher prices in an unsubsidised market benefit the domestic producers who now have a stronger incentive to supply the respective goods and services. Indeed, "many International Monetary Fund and all World Bank loans stress greater reliance on market incentives" (Nelson 1988, p. 93). Among those most strongly favoured are the peasants who were formerly exploited to the benefit of the politically more vocal urban dwellers. However, it is unlikely that the

peasants will be able to reap most of the profits created: the large landowners will react by raising the land rents and the prices for the inputs, the supply of which may be controlled by them. On balance, the price reforms demanded by the stabilization programme tend to be politically disadvantageous to the government in the short term, mainly because the city dwellers, whose support is important, are adversely affected.

The discussion of the main content of the conditionalities has revealed that implementation of the different measures would tend to threaten the government's utility and chance of survival. In the model developed in section II.2., the deterioration of the situation of the groups/population implies an inward shift of the support for the government. The exact amount of the shift to the left depends on the attribution of the different hardships caused by the stabilization programme. We will take up this point below. The government can react to the decline in support by reducing its own consumption and investing the resources in mustering more support. The crucial question is whether the government is able to compensate groups which lose in the short term and to weaken the politically deleterious effects by exploiting the extended possibility set offered by the credit received.

### 3. Extended Possibilities by Credits Received

#### *a. The Government's Possibility Set*

The following table gives a schematic overview of the benefits and costs associated with credits and conditionalities.

**Table 2:** Benefits and costs of credit and conditionalities from the government's point of view: appropriability and attributability

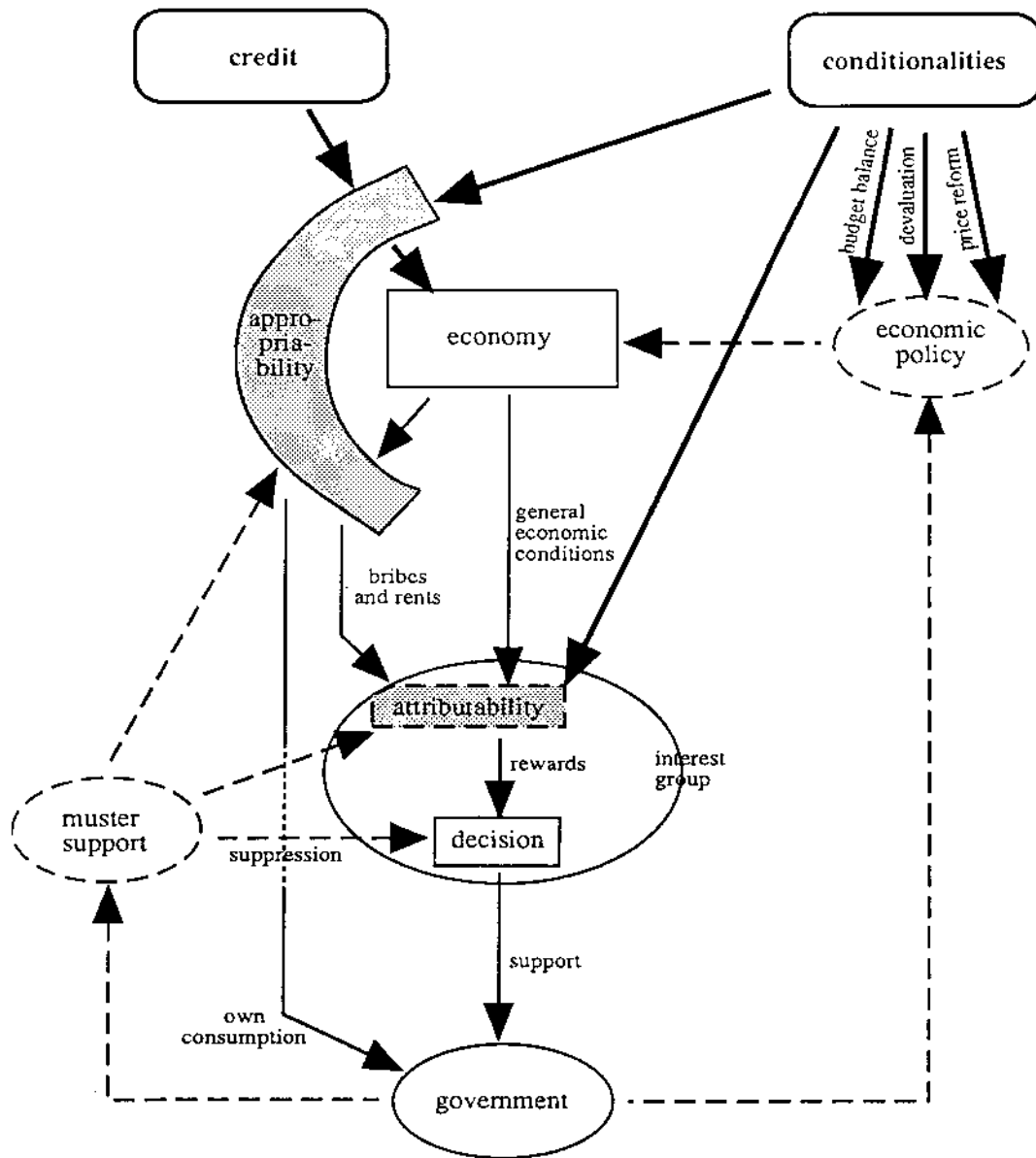
	<b>Benefits</b>	<b>Cost</b>
<b>Credit</b>	Appropriability of the funds (possibility of using for own purpose)	Attributability of the burden of – interest and – repayment
<b>Conditionalities</b>	Support by international financial community (prestige)  Credibility of programme undertaken	Attributability of negative effects of the stabilization programme – short-term recession – burden of budget, balance, devaluation and price reform  Reduction of appropriability possible



This table centres on the two concepts found to be crucial in the politico-economic interaction in developing countries:

- (i) The government can extend its possibility space and thereby its utility and survival chance if it is able to *appropriate* as much of the benefits of the credit as possible. The extension of the possibility space implies an outward shift of the government's support demand curve. There is considerable evidence that the government can indeed appropriate a large part of the credits either to consume itself or to dispense among sympathetic groups (see e.g. Sachs and Collins 1989 or Körner et al. 1986 and Körner 1988). One important manifestation of this appropriation is capital flight (see Khan and Ul Haque 1985, Varman 1989 or Bulow and Rogoff 1990). To a limited extent, there are also benefits resulting from the conditionalities: there may be a gain in prestige for the government undertaking the stabilization programme because of its association with the international financial institutions and the domestic groups may share it. Obviously, this effect tends to be slight, and is sometimes negative (i.e. it is a cost), namely when the government is negatively affected by being associated with the international financial institution (if it is considered to be a "lackey" of international financial capital).
- (ii) The government can reduce the cost of the credit and conditionalities (which relatively increases its possibility set) by having some of the cost attributed to *other* actors. The interest and repayment costs, for instance, can be attributed to a former government. The costs of the measures implied by the conditionalities can also be shifted, by attributing them to the international financial institutions which proposed the stabilization programme. Of course, the groups affected may not accept such an attribution.

Figure 10 illustrates graphically how appropriation and attribution connected with credits and conditionalities enter the basic politico-economic interactions in developing countries.



**Figure 10:** The stabilization programme: credit and conditionalities

This figure applies Figure 8 above to the situation arising when the politico-economic equilibrium is disrupted by credit from an international financial institution and its conditionalities. The figure shows that by appropriating part (or all) of the credit, the government can obtain more support by increasing the income flows to the various groups and to suppression, or it can use it for its own consumption, thereby raising the utility of the politicians in power. The figure also shows how the conditionalities affect the government's economic policy options, and how attriburability determines the extent to which the government is held responsible for the resulting (short-term) recession, as well as for the income flows transferred to the various groups. The main influence of the credit/conditionalities package can be illustrated in the demand-supply of support framework. Credit boosts the government's demand for support, and conditionalities reduce the groups' supply of support. The government can use credits to increase support directly but it has

another strategically interesting option of using the money to put the opposition at a disadvantage. Investing the money abroad offers the population two alternatives: (i) supporting the government and having the interest and reimbursements paid with these moneys; or (ii) supporting the opposition and repaying the credits by their own means<sup>(9)</sup>.

These aspects of appropriation and attribution pertaining to stabilization programmes will be discussed in depth below. Section 4 deals with attribution, section 5 discusses appropriation, and section 6 looks at the government's possibilities of insuring its survival in the context of the conditionalities.

#### 4. Attributability in Stabilization Programmes

##### *a. Recession Induced by Conditionalities*

If the implementation of a stabilization programme leads to a recession, the politicians in power do not in every case lose the support of the different groups in the society. Whether opposition increases (or support declines) depends on the extent to which the government is held responsible for the short-term worsening of the state of the economy due to the conditionalities imposed by the other political actors. The question, more precisely, is what conditions tend to exonerate the government for the costs.

- (i) It may be hypothesised that the government is perceived as being *less responsible* for the recession when more possibilities exist to shift the blame to the international financial institutions setting the conditionalities. Such a shift will be more possible if the government will be unlikely to need another credit in the near future. In this case the expected cost of making it more difficult to receive credits and to defend the decision to take a further credit is smaller.

A second hypothesis suggests that it is easier for non-market oriented governments to blame the international financial institutions. It would appear inconsistent if free-market and stability-oriented governments were to put the blame on these institutions.

- (ii) The government is also hypothesised to be *less blamed* for the recession, the less severe the recession is due to other, unidentified reasons. The government can then claim that the costs of raising the credit have been low due to its good economic policy and that it was therefore worthwhile to have obtained the credit. This hypothesis depends on the notion that it is difficult or impossible to establish what the economic conditions *would* have been in the absence of the conditionalities. Rather, the groups on whose support the government depends evaluate the state of the economy according to whether it is better or worse than before, and to what extent this is the case. While such a *before/after* comparison is scientifically unsound, and a careful

analysis would be based on the situations *with* and *without* a stabilization programme, even professional economists are often tempted by the before/after approach due to theoretical and empirical limitations (Edwards 1989), and tend to rely on the former, much simpler comparison (see Nelson 1988, pp. 89, 94). Econometric evidence for popularity and election functions support this hypothesis (see e.g. Paldam 1981). It is also consistent with the observation made in psycho-economic experiments, where it has been found that people do not generally take missed opportunities into account, e.g. opportunity cost is of smaller relevance than more direct, especially monetary cost (see Thaler 1980), and that people evaluate the behaviour of others by putting too much emphasis on the outcomes of their actions (Lipshitz 1989)<sup>(10)</sup>.

There are other situations in which the government is *less likely* to be burdened by the recession:

- (iii) The weaker the political opposition, the more the government is able to portray the credit decision in an advantageous way (see Kahneman and Tversky 1984). A well organised and vocal opposition makes it difficult for the government to attribute the cost of the recession to other actors.
- (iv) Unusual events, such as wars, natural catastrophes or failed harvests make it easier for the government to argue that such exogeneous shocks are the origin of the economic hardships.
- (v) If it is abundantly clear to all relevant groups that it was absolutely necessary to raise credit from an international financial institution, the government is then held less responsible for the poor short-term economic effects.

#### *b. Price Reforms*

As has been pointed out, conditionalities regularly require that the distorted price structures in some (or many) sectors of the economy be corrected. The question is to what extent the consequent benefits and cost are attributed to the government. The following hypotheses can be advanced:

- (i) When the price system is used for the allocation of resources, the *benefits* of the market tend to be attributed to impersonal forces and the government is given little credit for these benefits. Only if the opposition champions a planned economy, are the benefits of the market attributed to the government that introduced it. The same holds if the government visibly helps the price system to function, for instance, by undertaking a well publicised anti-trust policy, reducing tariffs or reducing regulations and bureaucracy. On the other hand, in a flexible economy the government easily appears to be "useless", and cannot

politically reap the benefits indirectly produced by the introduction and preservation of the market.

- (ii) The *cost* of changing the price structure and moving towards a competitive market are *more strongly attributed* to the government, the more counter intuitive the mechanism of the changes are. If the groups in society find it difficult to understand why it makes sense to raise the prices of highly subsidised goods, they resent the increased cost and hold the government responsible for the cost accruing to them. Attributability (to the government) is thus the larger:
- the less educated in economics the population is;
  - the less favourable past experiences with moving to a market economy have been (e.g. if the supply-response to the higher prices has been slow and/or negligible);
  - the stronger the "socialist" ideology and antimarket views are among the population (Nelson 1988, p. 93);
  - the stronger a technocratic illusion of control is among the elite (see again Nelson 1988, p. 93).
- (iii) The cost of introducing the price system is attributed more to the government, the larger and politically influential are the groups whose consumption depends essentially on the goods whose prices have risen as a consequence of the reforms. The most important of these goods are staples which make up around 70 per cent of total consumption expenditures of the urban dwellers in developing countries (Bates 1988b).
- (iv) Undesirable consequences of price reforms are attributed to the government, the greater losses are weighted relative to gains by the population. There is extensive literature in cognitive psychology based on experimental results (see Kahneman and Tversky 1979, Knetsch and Sinden 1984, 1987), suggesting that individuals perceive losses as greater changes in welfare than equal-size gains. This effect is the stronger:
- the more rapidly expectations adjust to gains than to losses. With the reference point changing in this way, more changes in the economic situation are accounted as losses, and less as gains<sup>(11)</sup>. In particular, expectations move more quickly upwards, the more promises the government has made concerning future improvements in economic conditions. The government is more tempted to make such promises (which it knows may backfire if not fulfilled), the lower its expectations of staying in power. A government seriously doubting its survival tends to undertake the risky strategy of rash promises, calculating that

if they are not kept, another government must deal with the dissatisfied population<sup>(12)</sup>.

- The losses will be felt more strongly than equivalent gains if the groups burdened are easily able to compare their situation with those favoured. This is the case when the urban working population is strongly hit by the price rises, while the rich visibly profit.
  - The perception of losses relative to gains is also increased, with the additional cost of price rises, such as increases in crime and begging. These consequences lower the information cost.
- (v) Another perception problem is also likely to raise the cost of the price reforms attributed to the government; people resent the price rises induced because many of them are unable to buy the goods now visibly displayed in the stores, tending to forget that at the previous low prices (which they liked) many of the goods were not available or were “rationed by waiting in queues”<sup>(13)</sup>.
- (vi) The size of the shadow economy existing before the price reform (i.e. when prices were controlled) may also influence the extent to which the government is held responsible for the cost of the price reform. If “reality” had been revealed to the consumers in the shadow economy<sup>(14)</sup> (where prices are much higher, but goods are available), then a price increase towards black-market prices is less likely to be resented. For example, an overvalued exchange rate is generally well understood by most people because the much lower value of the domestic currency on the black market is clearly visible. Under these circumstances, the cost attributed to the government of adjusting from the official to the free-market rate may be relatively small.

## 5. Appropriability of Credits

The extent to which the government can use the given credits depends on three main factors.

### *a. Differences between lenders*

By attaching conditionalities to the credits, the *International Monetary Fund* restricts the “political” use of its loans. To the extent possible the funds are earmarked for productive economic purposes so that the government cannot easily use the credit to enhance its own chances of survival or for consumption by reigning politicians (nor for ideologically motivated prestige projects). The question is, of course, to what extent the IMF is able to enforce these restrictions<sup>(15)</sup>. It may be hypothesised that the conditionalities are the better observed by the recipient government,

- the more monopolistic the IMF's position is, i.e. the more it can force the developing country's government to accept restrictions<sup>(16)</sup>;
- the less the IMF is interested in the survival of the politicians in power compared to a government made up of other politicians<sup>(17)</sup>;
- the more the credits can be divided into tranches - the idea being that future tranches are only disbursed if the recipient government has complied with the IMF's stipulations.

The credits given by the *World Bank (IBRD)* are mostly project-related, which restricts the amount the recipient government can appropriate for its own purposes. However, evidence (see e.g. *Neue Zürcher Zeitung*, 100, 1988, p. 7 on Brazil) suggests that only 25 per cent to 50 per cent of the funds actually reach the project level, that is the government, as well as other groups (to whom partly the government, in its own interest, grants this possibility) are able to appropriate a significant portion of the World Bank credits. Moreover, the government can indirectly appropriate part of the funds by selecting contractors whom it wants to benefit for the projects and by allowing them to overcharge for their services.

The extent to which project funds can be appropriated is larger:

- when the domestic rate of inflation is high (simply by holding back the foreign-currency credit for a period and using its rising value in terms of domestic money);
- when state firms or private domestic firms that are taxable comprise a large share of the contractors (it seems to be more difficult to appropriate funds from foreign contractors);
- when there is a large share of domestic inputs whose price the government can raise; and
- when a project cannot be split up into tranches, thus confronting the World Bank with an all-or-nothing proposition.

*Private lenders* (e.g. banks) find it even more difficult than the international financial institutions to restrict the appropriation of the credits by the recipient government. While one specific creditor has no incentive to monitor the government, private creditors as a group are interested in an efficient use of the resources because the repayment of the loan then becomes more probable. But because the restrictions on appropriations are applied by public bodies, private creditors have difficulty in becoming involved in this process. Moreover, the recipient government may be able to exploit the competition among lenders, which induces the lenders to alleviate the conditions under which the loans are granted.

### *b. Differences between recipients*

A credit from the International Monetary Fund normally goes to the central bank of the recipient country. If the central bank is independent, the government will find it difficult to appropriate the funds. However, in virtually all developing countries the central bank is highly dependent on the government, and can often simply be regarded as a branch of public bureaucracy.

In the case of World Bank credits, the credits normally go to the ministries in charge of the projects. The head of a ministry can in general easily be forced by the government to give it part or all of the funds. The head of the ministry has little interest in resisting such appropriation if his political survival is linked with the government; he may make an effort to resist only if he will retain his position whatever group of politicians is in power, which is rarely the case.

When a credit goes to a business actor, the government is the more easily able to appropriate the funds if the firm in question is wholly or partly state-controlled (which is often the case in developing countries, see, for example, Brazil), or where it is able to tax the recipient private firm (which includes bribes to the government).

### *c. Differences in forms of credit*

Credits which are given solely to service overdue foreign debt (interest and capital repayments) are difficult or impossible for the government to appropriate because such credits never enter the country but are disbursed directly to the creditors.

## **6. Effects of Conditionalities on the Government's Ability to Suppress Groups**

Conditionalities have little direct effect on how the government can use its resources in order to raise its chance of survival by suppressing groups, except to the extent to which the requirement to balance the budget forces the government to reduce its total expenditures. An indirect effect is often more relevant: a country receiving credit from international financial institutions becomes subject to the views of the institution's member countries. Therefore, it is probable that the suppression of certain groups reduces the chances of receiving future loans or at least raises its cost in terms of interest rates, repayment and other conditions.

There may, however, also be a reverse effect. Once a developing country has received a credit, the government can persuasively claim that the imposed conditionalities lead to revolts which it cannot tolerate. The connection established between conditionalities and the "need" to suppress unruly groups may strengthen the case for additional credits with milder conditionalities.



## VII. GOVERNMENT REACTIONS

The government has four major options for compensating for the (short-term) deterioration of economic conditions and the changes in attribution and appropriation discussed above. Its major effort will be to increase its chance of survival which falls as a result of implementing the conditionalities, but the selfish government politicians also have an individual interest in maintaining and, if possible, increasing their consumption level.

### 1. Change Economic Policy

If the government's survival is endangered, it will make an effort to implement economic policies which will improve its chances of staying in power. In developing countries this means, above all, following a policy which benefits those groups that pose a threat to the government. As is the case in democratic countries where the government needs to muster a sufficient share of votes at election time<sup>(18)</sup>, the government in a developing country is faced with a trade-off over time: an increase of its current chances of survival reduces the future chances of survival.

The government of an indebted country faces an additional constraint in its effort to survive - that which is imposed by the conditionalities. The more stringent these are, in particular the more compelling the demand for a balanced budget by the lending institution, the less the government is likely to succeed. It will therefore find it advantageous to change the conditions, once the credit has been received.

### 2. Change Conditionalities

The indebted government has two options available.

#### *a. Renegotiate the terms*

The government can bargain with the creditor institution to obtain less strict conditionalities. The two actors will reach such an agreement if the lender finds it advantageous. It may be in the creditor's interest to modify the conditionalities from three points of view:

(i) *Economic.* Under some conditions the value of the outstanding debt rises when the creditor forgives part of the debt. This will be the case if the downward sloping part of the "Debt Relief Laffer Curve" is reached: the improvement in economic conditions brought about by the reduction of interest payments and repayments or milder conditionalities may raise the probability of having the loan repaid sufficiently to outweigh the cost of that step<sup>(19)</sup>.

(ii) *Social*. As the conditionalities often strongly hit the poor in developing countries, the international financial institutions may come under pressure to relieve part of the burden of conditionalities because they fear the criticism of some member countries.

(iii) *Bureaucratic and political*. The lending institution finds itself in two quite different positions. *Ex ante*, before the loan is extended, and *ex post*, after the loan has been granted and disbursed. The difference is that in the latter situation the financing institution and the recipient country both have an interest that the credit produces some positive effect. The lending institution must justify to its member countries why it has given the credit to that particular country, and therefore makes an effort to prove that it was a wise decision.

If the developing country's politicians are rational, they are aware of these economic, social and bureaucratic/political incentives for the creditor to soften the conditionalities. This leads to a specific type of moral hazard because the government of a developing country has an incentive to steer developments so that the lending institution will renegotiate the contract in favour of the debtor<sup>(20)</sup>. As a result, an implicit or explicit renegotiation of the conditionalities is the rule, rather than the exception.

#### *b. Disregard terms*

While ostensibly upholding the formal agreement the developing country's government can one-sidedly get around or partly violate the conditionalities. It is possible to maintain a balanced budget while letting public expenditures exceed revenues by not including some outlays in the official budget (off-budget activities), a practice not unknown even in developed economies<sup>(21)</sup>.

A loosely organised government may find it relatively easy to disregard formal contract terms. In a country where no reliable public accounting exists, or where many different accounts coexist, it is difficult for the creditors to determine whether or not the conditionalities are being met.

### **3. Change Attribution**

As has been made clear above, the extent to which the recipient government is held responsible by the groups in the society is not predetermined and can be influenced by the manipulation of information, persuasion and camouflage. While these possibilities are mentioned in the literature (see e.g. Nelson 1988, pp. 115-117) it is not discussed under what conditions these strategies can be used effectively<sup>(22)</sup>. The pertinent question is why these avenues for improving the government's position are not always used, provided they are, as claimed, effective. There may be two explanations for the failure of governments to always resort to these measures:

- (i) The government may overlook the possibility of improving its position. This explanation is not convincing; governments in developing countries have, on the contrary, shown an exceedingly lively imagination and talent for survival;
- (ii) The government does not find it easy to shift the attribution because the population is not so easily deceived<sup>(23)</sup>. Bearing in mind the existing conditions in developing countries it would be too extreme to assume (fully) rational expectations in which a systematic deception could be excluded. What seems more likely is that as a result of bad experience people in such countries have become so cynical that they refuse to believe anything the government proclaims. In these circumstances the government can still shift attribution by exploiting the anomalies<sup>(24)</sup> to which individuals are subject. One such anomaly the government can exploit is time subjectivity (see Frank 1988, Loewenstein and Thaler 1989), that is the tendency of people to discount the near future to a greater extent than more distant events; for this reason people often discount the future much more than they would have wished *ex post*. More importantly, the government can "frame" (see Kahnemann and Tversky 1984 and Quattrone and Tversky 1988) the issues so that the benefits of a credit are attributed to it, while the cost is not, or only partly. Examples of framing include the reduction in the weight of a loaf of bread while keeping the price constant (for evidence, see Nelson 1988, p. 117) and fixing subsidies in nominal terms while prices rise (Nelson 1988, p. 117). In general, the government can shift the attribution in its favour by establishing a more advantageous reference point. Such a strategy is not easy to undertake, because the people concerned may reject the attempt to frame their views, especially if the opposition points out that the government misuses framing for its own purpose. There are thus clear limits to shifting attribution, especially if one takes into account that the most obvious and easiest exploitable possibilities have already been used.

#### 4. Change Appropriation

The government can try to appropriate a greater share of the economy's resources in order to improve its survival probability. However, as has been discussed above, the conditionalities partly prevent such action. The increased use of a price system demanded by the conditionalities is disadvantageous for a government that wants to appropriate resources in order to raise its survival, because the advantages of using markets benefit both the supporters *and* the opponents of the government. The politicians in power lose instruments for delivering benefits to groups whose increased support they desire. The government then has to resort to *substitutes* which, from its own point of view, are less efficient

but which, nevertheless, are used, as they are not restricted by the conditions of the loan. Such "new" instruments are:

- regulations to create rents for supporters;
- changing the distribution of regional projects in order to increase support;
- the increased suppression and punishment of opponents.

## VIII. POLITICO-ECONOMIC OUTCOMES OF STABILIZATION PROGRAMMES

To analyse the result of the implementation of various types of stabilization programmes, the elements of the interaction between the economy and polity must be integrated. Due to the many different aspects involved it is neither possible nor useful to present any closed formal solution; rather, the effects of stabilization programmes are analysed first by considering *five scenarios*. Each of these scenarios is characterised by a particular set of conditionalities imposed by the international monetary institution. The outcomes will be compared and systematised in the form of a table. Then we will analyse how different institutional conditions impinge on the effectiveness of stabilization programmes, concentrating on the mechanisms of appropriation and attribution.

### 1. Effects of Conditionalities and Credit

#### *a. Credit without conditionalities*

In this scenario, a developing country receives a credit from an international financial institution without any strings attached. The recipient government can use the additional resources as it sees fit, i.e. in a way which increases its own utility as much as possible. In the *short term* the government politicians want to raise their own consumption but also secure their political survival. Therefore, credit will increase the demand for support. The resulting higher level of support can be achieved by devoting part of the additional resources to improving general economic conditions (e.g. by undertaking appropriate investments), increasing positive sanctions to the population via monetary and other transfers (bribes), and increasing negative sanctions (suppression) by increased expenditures for the police, secret service and army. The remainder of the credit is used by the politicians in power for consumption.

The result of this scenario is not particularly attractive from the point of view of an outside observer. While economic conditions are likely to improve somewhat, there is more suppression (i.e. political conditions deteriorate) and the resource use is increasingly unproductive (more is spent for transfers and politicians' own consumption). In Table 3 position A is reached.

**Table 3: Short-term outcomes of five scenarios**

Evaluation in terms of economic and political conditions  
and of the productivity of resource use

		Government's resource use	Economic conditions (general state of the economy)	
			improving	worsening
Political	less suppression	more productive	ideal	
		less productive	C	D
conditions	more suppression	more productive		B
		less productive	A	B'

Note: Government's use of resources is defined to be more (less) productive if the expenditures on bribes and on government politicians' own consumption is reduced (increased).

In the *long run*, due to the investments undertaken, economic conditions tend to improve, but this is overbalanced by the government's unwillingness or inability to undertake the necessary economic reforms, in particular to balance the budget and significantly reduce the severe price distortions. As a result, the economy will stagnate but bribes and politicians' consumption are likely to increase further. It follows that the international financial institutions should not, even for purely economical reasons, impose no conditionalities on recipient countries. This conclusion holds even more strongly if, in addition, the political consequences are taken into account. To assist a typical authoritarian government in a developing country by just giving credit results in more politically induced waste, and, more importantly, in a greater suppression of the population by the politicians in power.

*b. Credits and classical conditionalities*

"Classical" conditionalities are defined as being the economic strings attached to credits which are currently imposed by the international financial institutions. As has been pointed out in section VI they mainly consist of balancing the government budget, devaluating the currency and undertaking price reforms (ending the major price distortions). These prescriptions typically lead to a recession but establishes the necessary basis for future economic growth. The conditionalities also make it more difficult for the government to use bribes to enhance political support because the transfers involved often take the form of granting a monopoly position to particular groups, or subsidizing the price of goods

which are of particular importance for certain groups. For example, supplying basic foodstuffs, electricity and transport at prices below cost often requires very large subsidies by the government. Since such price distortions must be eliminated if the credit is obtained under the regime of classical conditionalities, the government is certain to lose support from the population negatively affected. There have been many cases in which such price reforms have led to violent political eruptions and attempted (and even successful) take-overs and revolutions. The government, being aware of this, will consequently try to increase its support by stepping up negative sanctions. Political suppression becomes a less costly activity in comparison to bribes, and is therefore relatively stepped up. While the conditionality which stipulates that the budget must be balanced sets limits to the amount of reserves additionally devoted to the police and military, at the same time the credit increases the government's spending capacity. The larger the share of the credit the politicians in power can appropriate for their own use, the more suppression increases. In the model developed in section III limited possibilities of the government to muster support result in a leftward shift of the supply of support function. On the other hand, credit induces a rightward shift of the demand for support function (income effect). Therefore, support becomes more expensive (compared to own consumption), which means that government consumes more but musters less support. At the same time the relative efficiency of the policy instruments changes in favour of suppression. On the whole, support for the government will most probably decrease. Only if the credit is big enough to counterbalance the negative effects of the conditionalities on the supply of support, will support remain constant or even increase. Credits of this size would also further expand own consumption, suppression and bribes. Whether the politicians in power are able to raise their own consumption in absolute terms depends on three countervailing forces: the share of the credit appropriated tends to raise own consumption (income effect) while the conditionalities tend, on the one hand, to increase it (substitution effect) and on the other, to reduce it (income effect). In many cases the first two forces will dominate, so that the government uses the resources less productively: both bribery and own consumption increase.

In Table 3 position B or B' is reached. The short-term outcome of the stabilization programme has the same unfortunate consequence as a credit without conditionalities (position A) because political suppression increases, but the overall result is even worse, because over the short term, economic conditions deteriorate and consumption and waste increase. These negative consequences of credits extended under classical conditionalities have often been observed and have been widely discussed. These results have given rise to opposition by vociferous political groups in western countries against the policies of the International Monetary Fund and the World Bank.

Concerning political stability, two cases must be distinguished:

- (i) The government *survives* by extensive suppression of the population. As a consequence of the economic stabilization programme, the state of the economy slowly improves which raises the support received by the

government. This allows the politicians in power to reduce suppression. The beneficial outcome over the longer term is only marred by the fact that in line with improved economic conditions, the politicians in power increase their own consumption.

- (ii) The government is unable to halt the decline support, i.e. suppression is unable to compensate for the reduction in bribes and the effect of deteriorating economic conditions. As a result the government is toppled and the opposition takes over. The crucial question is whether the population attributes the recession to the new government. If the new politicians in power are not held responsible, they enjoy more support than the politicians who have been ousted. In any case, they have less incentive to suppress the population and, due to their longer time horizon, it is worth their while to create instruments designed to improve future general economic conditions.

If, on the other hand, the population attributes the existing state of the economy to the new government, political instability, coupled with a weak long-term economic performance is the result. Each new government is unable to consolidate its position and therefore has little incentive to invest in the future. Rather, it will try to raise its own consumption as quickly as possible and tries to stay a short time in power by political repression. Clearly, such an outcome is undesirable from the point of view of lending financial institutions.

### *c. Credit and political conditionalities*

The international financial institution in this scenario extends credit to a developing country only if the latter is prepared not to suppress its population politically. The credit not only has the economic objective of furthering growth but also the political objective of guaranteeing human rights. No economic conditions are imposed. The conditionalities raise the cost of mustering support and the government will therefore try to substitute consumption for support. At the same time, credit enables the government to raise its own consumption even more. In the short term the credit (if not fully appropriated by the politicians in the recipient country) tends to improve the state of the economy, and the government seeks to guarantee its survival by increasing positive sanctions for the population in exchange for political support (as it has to forego suppression). The outcome is indicated by position C in Table 3.

Compared to the first scenario without conditionalities, economic conditions are also favourable over the short term, but political conditions are better because the population is suppressed less. However, there is a considerable amount of waste in bribes and the own consumption of the politicians in power is higher as a result of the credit.

Over the longer term the economic outlook largely depends on the evolution of the political system: if the reduction of suppression allows the opposing



groups to organise and political competition is strengthened, it is quite possible that the economy will recover. However, if the government is able to prevent the development of a well organised opposition, the outlook is bleak because the necessary economic reforms will not be undertaken. The economy is bound to stagnate and, due to the more unproductive use of resources, may even go into recession. As this threatens the government's survival it tries to raise support by continually increasing bribes which only worsens the economic situation in the long run. The question is, how long an authoritarian government in a developing country is prepared to keep its promise not to increase its chances of survival by suppressing the population. In the case of a one-time credit, the incentive to respect human and political rights vanishes once the credit has been received. There is an incentive to keep the promise if the credit is given in tranches and will be withheld if the population is repressed. Whether the optimistic or the pessimistic scenario will come to pass is very difficult to predict. However, appropriation is again an important factor. The larger the share of the credit the government can appropriate, the more the government is able to bribe the leaders of opposing groups, and an effective political competition becomes more unlikely.

#### *d. Credit and both classical and political conditionalities*

This scenario is a combination of the second and third scenarios. Due to the economic conditionalities the economy is bound to deteriorate in the short term. There is a reduction in the repression of the population, but not by as much as in the previous scenario, because the government has to use all the instruments it has at hand to muster support, since the deterioration of the economy leads to a lack of support, and the possibilities of bribery are also restricted. Since the government politicians are aware that they will be in power for only a short period, they do not make any economic investments but rather increase their own consumption as quickly and as fully as possible. While the population is not suppressed it is nevertheless exploited by its government to a larger extent than in any of the previous scenarios.

In Table 3 position D is reached. Whether total waste actually increases depends on whether the increase in own consumption undertaken by the politicians in power is larger than the decrease in bribes imposed by the economic conditionalities. As there are many ways to circumvent the promise to reduce the extent of positive sanctions significantly, while the incentive to raise one's own consumption is implicit for the politicians in power, it is likely that resources are used in more unproductive ways (which is assumed to hold in table 3).

Over the long term the state of the economy tends to improve because the conditionalities impose the most urgently needed economic reforms. However, due to its short time horizon the government (expecting to lose power soon) does not invest and the less productive use of resources (higher own consumption by the politicians in power) puts a further burden on the economy. Normally, the new government will not benefit from the credit as the recipient government has made great efforts to appropriate as much as possible, and to spend the money as soon

as it is received. If indeed no part of the credit is left over, the new government will not feel bound by the conditionalities and will step up both positive and negative sanctions to a level comparable to the situation existing before the credit was granted. Under these realistic conditions the credit has little effect on longer term economic development because the potential for future growth created by the economic stabilization programme is wasted by political interference in the recipient country.

*e. An "ideal" scenario*

The scenarios discussed so far all lead to pessimistic conclusions: when credits are given without strings attached, as well as when economic and/or other conditionalities are imposed, the economic and political situation tends to deteriorate rather than improve. The present scenario states the conditionalities which are necessary for a beneficial economic and political outcome.

The discussion of the first scenario has shown that credit without conditionalities does not achieve its aim. Moreover, the desired outcome is not achieved if the conditionalities refer either to the economy ("classical" conditionalities) or to the polity (human rights approach). Combining the two types of conditionalities, as in the previous scenario, may even make the outlook worse because the governments of the recipient countries are induced to raise their own consumption so much that development is crippled.

One solution is to extend the (political) conditionalities even further: credit is only provided if the government does not raise its own consumption. Obviously, such conditions involve major monitoring problems and are often unfeasible for this reason. However, the international financial institutions may respond by allocating credits in tranches which can be discontinued if too large a share is appropriated by the politicians in power.

Another solution focuses on the recipient government's motivation for raising its own consumption. Since this conduct is encouraged by limited chances of survival and a short time horizon, the international financial institution may try to increase the government's expected time in office. Since the creditors' possibility to interfere in the domestic policies of the recipient country is severely limited (the charge of neo-imperialism is likely), a guarantee for political stability can only be achieved in a democratically acceptable way by a voluntary contract between the international financial institution and the politicians both in and out of office. The creditor must make sure that the (potential) opposition will not try to topple the government within a specified period of time. This moratorium is attained by forming a government composed of both the current politicians and those in the opposition. Many countries in times of peril have resorted to coalition government. However, this sort of solution is not easy to achieve and it does not necessarily work. An all-encompassing coalition of politicians may reduce the incentives for further economic growth, and there is a great danger that a broad coalition will develop into a cartel against the population. Therefore, such a condition may lead to a new

kind of opposition (possibly a guerilla movement) which is even more difficult to control. Since these opposing groups often use force, it is easy for the government coalition to justify the resumption of suppression even within the limits of political conditionalities.

A third solution also focusing on the government's motivation is increasing the efficiency of its bribing the population. The share of resources needed to muster a particular amount of political support is thereby reduced, and resources are freed for investment in productive uses, i.e. for economic development. At first, this solution appears rather strange but its widespread use by industrial countries shows that it is not quite so outlandish. In industrial democracies governments "buy" the political support of the agricultural lobby by guaranteeing farmers an adequate means of living. In most countries this is achieved by setting minimum prices for agricultural products. It has long been argued by economists that the same goal could be achieved at a much lower cost, not by distorting prices but by handing out direct subsidies in terms of money (guaranteed income). The solution discussed in the context of stabilization programmes in developing countries generalises this suggestion. However, this solution is not easy to achieve as is evident from the strong opposition by farmers to the proposed change in policy. In recent years, this opposition has been worn down, indicating that making bribes more efficient may not be altogether impossible in developing countries also.

## **2. Effects of Institutional Conditions**

### *a. Appropriability*

The extent of appropriation is crucial for the success of a stabilization programme. Being aimed directly at the credit, or taking place at the level of the economy, appropriation allows the government to take more of the country's resources which have been enlarged through credit. The greater appropriability is, the more government can consume, and the higher is the probability of survival and therewith the support it demands. Since government has more resources for discretionary use, the relative prices of bribe and suppression go down, whereby the relative price of economic policy goes up. The government therefore relies more on bribes and suppression and reduces its effort to provide a solid economic policy.

This leads to the conclusion that in countries where appropriation is relatively large (where the government sector is relatively extensive, the central bank is directly dependent on the government, etc.), stabilization programmes will be less successful.

### *b. Attributability*

A government loses support the more a recession induced by a stabilization programme is attributed to it. The government can react in two ways: if it considers the situation hopeless, it can try to consume as much as possible (the "après moi le déluge" strategy). Or, if it sees some hope of staying in power, it can increase its

probability of survival by reducing own consumption and increasing bribery and suppression, and improving economic conditions. The latter will be the better strategy, the greater the attribution. The converse case is intuitively more plausible. If the recession is not attributed to the government, the government does not lose support. Therefore it is able to use the credit for its own purpose, that is it can increase own consumption and its support by increasing bribes and suppression, facing no incentives to improve the economic conditions.

This leads to the conclusion that a stabilization programme is more effective from the point of view of the international financial institutions, the higher the attributability of the economic consequences. This result suggests that stabilization programmes are relatively ineffective if they are implemented in countries where there is a war in the region or guerilla warfare in one of its provinces, for example, where there are often natural disasters, where the government controls the media, or when the world economy is in recession (for other examples of conditions influencing attributability see section IV).

## IX. CONCLUDING REMARKS

This report distinguishes itself in two major respects from many other analyses of the impact of stabilization programmes on developing countries.

*Methodologically*, the rational choice model is applied to all actors. In particular, the politicians in and out of government are taken to be selfish: they are interested in staying in power and being able to consume for themselves as much as possible. The actors are taken to be rational in the sense that they are capable of perceiving what lies in their interest. They have an incentive to inform themselves sufficiently so that they can meaningfully evaluate the marginal benefits and costs of alternative actions. The politicians in power apply the instruments available to them "optimally". They compare the marginal net benefits of raising their own consumption *versus* increasing the chance of staying in power; to increase support by improving general economic conditions *versus* sanctioning the population, or to increase support by increasing bribes (positive sanctions) *versus* suppression (negative sanctions). In the same way, groups rationally evaluate whether it is advantageous to them to ally themselves more strongly with the government or with the opposition.

In addition to the rational choice considerations used in orthodox economic theory, much emphasis is put on cognitive (psychological) aspects in decision making. Attributability plays a central role in the model: the extent to which the government is held responsible or accountable for the positive impacts of the received credits, and (over the short term) the negative impacts of "classical" (economic) conditionalities is not given but depends on a number of identifiable factors. The (objectively) same change in economic conditions - for example a recession induced by the need to balance the budget and reduce price distortions - thus may have a quite different impact on the government's chances of survival and thus on its behaviour, depending on the way these objective conditions are perceived.

The second distinguishing feature of this report is with respect to *content*. The economy and the polity are integrated. In standard economics there exist a great many analyses of the effect of stabilization programmes on the state of the economy, but the impact on the government is disregarded, and thus how the government in turn affects the economy when its survival expectations change is not taken into account. In political science, on the other hand, the political aspects are at the centre, and the economic process is treated cursorily, if at all. (Methodologically, the sociological approach basically deviating from the marginalist, the rational choice approach dominates.)

This report studies the effect of credits and different variants of conditionalities on the standard of living in the short and long terms, and also the effect on the government politicians' own consumption of goods, as well as on the extent of corruption by bribery. Most importantly, the study focuses on the extent of

repression of the population and particular groups – the violation of human rights. Conditions under which the economic and the political conditions improve for the population are identified and corresponding testable propositions were formulated.

Four scenarios were evaluated to show the effects of particular economic and political conditionalities attached to the credits. The results were rather pessimistic. When “classical” economic conditionalities are imposed which serve to improve the economic conditions in the recipient country in the long run, an economic recession is unavoidable in the short term (mainly because government expenditures have to be balanced by tax revenues, and distorted prices have to be eliminated). At the same time the population is suppressed by more use of force.

Political conditionalities (if they are indeed followed) can be used to prevent such unfortunate consequences of stabilization programmes but they tend to increase consumption in the form of bribes from the government to selected groups, as well as increased consumption by the politicians in power. When political and classical economic conditionalities are combined, there is also a short-term deterioration of economic conditions which tends to increase corruption and the government's own consumption even more.

The report also considers more favourable economic *and* political outcomes (“ideal” scenario). In order to insure the necessary structural changes for long-term development, credits have to be linked with classical (economic) conditionalities. To prevent increased violations of human rights and to safeguard (reasonably) democratic conditions, it also seems necessary to link credits with political conditionalities. As a country tends to deviate from these conditionalities as soon as it has received a credit (although the reduction of credibility and reputation also implies costs for the government), it makes sense to grant credits in tranches, and to discontinue or reduce them when the economic and/or political conditionalities are not met. At the same time, an “ideal” policy should prevent corruption from increasing and the government politicians from exploiting the economy for their own consumption, which is encouraged when the politicians in power appear to have limited chances of survival. This situation could be remedied by a voluntary accord between the government and the opposition. But such a “national coalition” may be unrealisable or it may result in exploitation of the government by politicians both in and outside government. Another possibility for increasing the government's chances of survival is to enhance the efficiency of “buying” support from the major groups. This can be done by supporting development programmes which efficiently transfer income to the groups whose support the government needs. A different, and, in the long term, superior way to reduce consumption and own consumption by the politicians in power is to increase political competition which forces the government to follow the wishes of the population more closely. This policy implies that the international financial institutions establish contact with the politicians in government and also with the opposition. This helps the latter to be better informed, and enables them to set forth a more compelling programme to compete for the population's support. These considerations make it clear that a stabilization programme by international

financial institutions which takes human rights and corruption of all sorts seriously, must take into account the changes induced by the credits and conditionalities in both the economic and political spheres.

## NOTES

1. Politico-economic models of representative democracies are discussed in Frey (1978, 1983), Schneider and Frey (1988) or Mueller (1989). The activities of interest groups in a parliamentary context has received special attention in van Winden's (1983) work, while Schneider, Pommerehne and Frey (1981) worked within the context of a direct democracy, namely Switzerland.
2. Compare Wintrobe (1990) or Bloch (1986). Wintrobe introduces exogenously given minimum power the government wants to have, while Bloch formulates an exogenously given maximal deprivation people are willing to bear.
3. See e.g. Frey (1984), North (1986), Ostrom (1989), Eggertsson (1990) or Williamson (1991).
4. For overviews from the economic point of view see e.g. Schoemaker (1982), Thaler (1987), Machina (1987) or Eichenberger (1991) and for overviews from the psychological point of view see Slovic, Fischhoff and Lichtenstein (1977), Payne (1982) and Hogarth (1987, 1990).
5. See e.g. Hibbs (1987), or even more explicitly, Frey (1983). Overviews are provided by Mueller (1989) and with emphasis on the politico-economic cycles, Nordhaus (1989), Alesina (1989) or Schneider and Frey (1988).
6. This can also be seen in political science work which applies the economic approach. For an early, impressive account, see Ilichman and Uphoff (1969). More recent work is collected in Bates (1988a) and Nelson (1989, 1990).
7. While a large body of literature exists on the effect of economic conditions on the popularity and re-election chances of the government for democratic countries (see the literature cited in note 1) and to a more limited degree for (former) communist countries (e.g. Lafay 1981) little is known about authoritarian, developing countries (a partial example is, however, Paldam 1987).
8. The conditionalities are seen as a "cost" by the recipient governments. If this were not the case, they would have undertaken the programmes themselves. This statement must be qualified in two respects: (i) The government may make an error or may not be as well informed as the experts in the international financial institutions. According to this "paternalistic" point of view the governments of developing countries must be "forced" to see what policies are to their own benefit. This view is not adopted in the present essay; it is assumed that government politicians act rationally and are able to see what is to their benefit. It must be stressed again that "benefits" and "cost" as used here refer to the government, and not to the country as a whole, or to a mystical social welfare. (ii) The government of a developing country may be unable to muster the energy and the resources required to undertake a stabilization



programme, and needs the impetus coming from outside the country, in particular from a recognised international financial institution.

9. The empirical notion that the implementation of conditionalities stabilizes the governments (e.g. Sidell 1988) of developing countries is well compatible with the idea of credits putting the government at a strategic advantage. In addition to this, in countries that have not already a huge debt it is the more interesting for the opposition or for rent-seekers to take over power, because they can then raise credit and appropriate it.
10. For general surveys of the "anomalies" literature, see the literature quoted in note 5.
11. This corresponds to the Duesenberry effect in consumption theory (Duesenberry 1949).
12. This corresponds to a situation in which the current government burdens the future population with a high public debt whose cost may fall on the future government. See Alesina and Tabellini (1990).
13. Surveys clearly suggest that rationing by price is considered less fair by consumers than an allocation by tradition (first come, first served, i.e. by waiting) or by an administrative unit. Evidence for Canada is presented in Kahnemann, Knetsch and Thaler (1986), for Germany and Switzerland by Frey and Gygi (1988) and Frey and Pommerehne (1992).
14. For economic analyses of the shadow economy in general see Frey and Pommerehne (1984) and Feige (1989) and for developing countries in particular, de Soto (1989).
15. Whether the IMF officials have an interest in doing so is not discussed in this paper which takes the behaviour of the lending institutions as given.
16. Here again, the behaviour of the credit institutions is taken as given. If the international financial institutions are endogenized, monopolisation need not lead to a thorough enforcement of the conditionalities.
17. The political views of the IMF directorate clearly enter into the picture here but the analyses of them are beyond the scope of this paper. See Dreyer and Schotter (1980) for the determination of the *a priori* power distribution (the Shubik-Shapley value) in the IMF, and Frey and Schneider (1986) for a respective analysis of World Bank behaviour.
18. This has been extensively discussed in the framework of the political business cycle. See the literature quoted in note 5.
19. On the Debt Relief Laffer Curve see Krugman (1989) or Kenen (1990).

20. Evidence exists, for example, that the Ethiopian government has channelled the help provided by the industrial countries so that conditions (a), (c) and, in particular, (b) are strengthened. See Glucksmann and Wolton (1986).
21. Off-budget activities are discussed generally in Brennan and Buchanan (1980) and Aronson and Ordeshook (1981).
22. The same holds for the related concepts of the exploitation of *fiscal illusion* (see Buchanan and Wagner 1977, Pommerehne and Schneider 1978 or Oates 1988) and *obfuscation* in the case of protectionistic measures (see Magee, Brock and Young 1989, ch. 18).
23. On this point, see the literature on rational expectations.
24. See Kahnemann, Slovic and Tversky (1982), Hogarth and Reder (1987) and Dawes (1988). For a discussion of the arguments against the relevance of such anomalies see Frey and Eichenberger (1989a) and Eichenberger (1991).

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