THE POLITICAL ECONOMY OF STRUCTURAL ADJUSTMENT

Promises and Signals: The Role of Donor Agencies

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ABSTRACT

This paper provides a model of utility maximizing governments to explain when and why countries adopt or discontinue a structural adjustment program (SAP), in an attempt to stabilize and liberalize their economies. Assuming a rent-seeking government, the model shows that compliance with an SAP is endogenous. Consequently, the key issue is to study the factors that affect the equilibrium rent-extracting rate. The paper identifies several incentives either to announce an SAP, though without implementing it, or to reverse one. These incentives are suggested as a possible explanation for the low investment rates observed in countries implementing SAPs. The paper also argues that the implementation of an SAP for a period of time long enough to bring about structural changes in the economy would, likewise, alter the equilibrium rent-extracting rate and would consolidate reforms.

The paper also analyzes the negotiations between 'technocrats' and 'politicians' and their consequences on the type, quality and the probabilities of success of the SAP adopted. The paper argues that orthodox theorists are the generators of high quality programs. In addition, the possible role of donor agencies in signalling the quality of the program is pointed out.

The paper ascribes an important role to donor agencies in the successful achievement of an SAP, as they signal, on the one hand, the government's long run commitment with the program and, on the other hand, the program's quality, giving a clear-cut solution to the time inconsistency problem faced by rent-seeking governments.

SÍNTESIS

Este trabajo presenta un modelo de gobiernos que maximizan utilidad para explicar cuándo y por qué los países, en un esfuerzo por estabilizar y liberalizar sus economías, adoptan programas de ajuste estructurales (PAE). Suponiendo un gobierno que busca extraer rentas, el modelo pone de manifiesto que el cumplimiento de un PAE es endógeno. Por lo tanto, el problema fundamental estriba en estudiar los factores que afectan la tasa de extracción de rentas de equilibrio. Asimismo, el documento identifica diversos incentivos para anunciar un PAE, pero sin que por ello se lleve a cabo o bien para dejar sin efecto un PAE, y señala que constituirían una posible explicación de las bajas tasas de inversión observadas en países que implementan estos PAE. El trabajo también plantea que la puesta en práctica de un PAE, por un período de tiempo lo suficientemente largo

como para producir cambios estructurales en la economía, alteraría, asimismo, la tasa de extracción de rentas de equilibrio y consolidaría las reformas.

A continuación, el trabajo analiza las negociaciones entre los 'tecnócratas' y los 'políticos' y sus efectos sobre el tipo, calidad y probabilidades de éxito del PAE adoptado. Se plantea que los teóricos ortodoxos son los generadores de programas de alta calidad. Adicionalmente, se plantea el posible rol de los organismos de apoyo financiero como emisores de señales acerca de la calidad del programa.

El documento asigna a los organismos de apoyo financiero un rol importante en el logro exitoso del PAE, pues al señalar, de una parte, el compromiso de largo plazo que asume el gobierno con el programa y, de otra parte, la calidad del programa, da una solución al problema de inconsistencia intertemporal que encaran los gobiernos que buscan extraer rentas.

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1. INTRODUCTION

Lately, several countries have attempted to stabilize and liberalize their economies (i.e. to establish a structural adjustment program -SAP), only to abandon the effort some months later. Argentina (until recently) and Brazil are the most notorious cases. Given that adopting such a program implies intellectual and political efforts that are lost when the program is dropped, why would a country start an SAP and then stop implementing it? Is it lack of political will? Is it that the package was inadequate, and consequently implied unexpected costs? To this we should add a disturbing empirical finding in the review of SAPs by the World Bank: investment decreases in countries with SAPs, possibly diminishing the expected benefits from adjustment. Since there is an intimate relationship between investment (growth) and beliefs about the sustainability of the structural reforms, the low investment level could be related to a low credibility of the government. The issue then is how the government is able to signal its commitment to deliver the reforms it has promised. This paper provides a rationale for a positive role for donor agencies in the signaling process, as opposed to Rodrik (1989).

In this paper, I work with a model of utility maximizing governments to see when and why the government will adopt and then discontinue an SAP. Then, I analyze the negotiations within the government, between 'technocrats' and 'politicians' and assess the consequences of this negotiation on the type of package adopted, its quality and the perception on the success of the program. On both issues I analyze the potential role of donor agencies in assisting in the successful implementation of an SAP.

2. THE POLITICAL ECONOMY OF STRUCTURAL ADJUSTMENT

To answer the question of when and why a country adopts an SAP, we will position ourselves in the case where the adoption of the SAP is not dependent on the ethereal concept of political will, but rather can be modelled as a consequence of optimizing behavior by the government[1]. Following Lal (1988), we will assume the government has a rent-seeking behavior, and its utility is directly proportional to how much rent it can obtain, either to keep it or redistribute it to friends, voters and partners. This is not equivalent to tax revenues as many rents are created and distributed through regulations or controls. Therefore, the government's utility is related to the rent-extracting rate (RER), α, and the level of GDP (for simplicity we assume total GDP is the relevant base).

The government is faced with an intertemporal problem, as the growth rate depends on the RER: more rents created and redistributed in period one means less GDP in period two; besides, the government will be in power for only a given period (or, better still, there is a probability distribution that depends on policy variables and exogenous shocks, that determines its possibilities of sharing in tomorrow's wealth -or lack thereof). For simplicity, we will make this a two period problem.

An SAP can be interpreted as a reduction in α, the rents extracted and redistributed by the government (Lal, 1987; Mosley, 1987; Sapelli, 1992). This means an SAP inflicts a short run cost to the government, with a long run benefit, due to the increase in GDP that should follow structural adjustment. There is, of course, another part to the SAP, and that is the money disbursed by donors and multilaterals. This is a short run benefit for the government.

The problem that the government faces, with no reform, is the following:

$$\max_{\alpha} \; \alpha(t) \; GDP(t) \; + \; \alpha(t+1) \; GDP(t+1) \qquad \text{where}$$

$$GDP(t+1) = g \; GDP(t)$$
$$g = g(\alpha), \text{ with } g'(\alpha) \text{ negative.}$$

In this case, we assume the government will remain in office for both periods. It has to fix α to maximize the rents extracted from the country's income flow. Assuming $\alpha(t) = \alpha(t+1)$, then we obtain equilibrium where $E(g,\alpha) = -(1+g)/g$,

[1] This is an essential difference between this paper and Rodrik's (1989) paper. He works with a world with two types of possible governments (a liberalizing and a redistributive government) and the key issue is to sort between both. In this process of sorting the donor agency adds confusion since it provides an incentive to the redistributive government to liberalize. I work with only one type of government (akin to his redistributive type) and ask how incentives can be provided for it to sustain an SAP and how it can signal its willingness to deliver.

i.e., where the elasticity of growth with respect to the RER is equal to approximately -2. This means, not surprisingly, that the government behaves as a monopolist and is positioned in the elastic part of the curve. The rent extraction equilibrium level will be higher, the higher the growth rate (g), and lower the more responsive g is to changes in α. The responsiveness depends, among other things, on the quality of the reform package. The determinants of this quality will be discussed in Section 3.

The above results are influenced by the assumption that there is no possible change in government. If we introduce a positive probability of going out of office (p), the equilibrium extraction rate depends crucially on the effect of an SAP on growth and the perception of that effect by the electorate. We assume p is a function of the growth rate, and we further assume people foresee the effect of a reduction in α on the growth rate. So we have:

$$\max_{\alpha} \; \alpha(t) \; GDP(t) + p \; \alpha(t+1) \; GDP(t+1), \text{ where}$$

$$1 < p < 0, \; p = p(g), \text{ with } p'(g) \text{ positive.}$$

Now the FOC says that $E(g,\alpha) = -[\{ (1+pg) / pg \} + E(p,\alpha)]$.

This means that the RER will now be determined by the probability of reelection and the elasticity of this probability with respect to adjustment (through the effect of adjustment on growth). Even if p is practically one, when the elasticity is large (i.e., the probability of reelection is very sensitive to changes in the RER), the optimal RER will be lower and the growth rate will be higher than in the case with no elections. Ceteris paribus, the lower the probability of reelection, the higher the RER; the lower the elasticity of reelection with respect to adjustment, the higher the RER. Therefore, 'democracy' introduces competition into the problem, and raises the growth rate (Scully, 1988), if there is an economic program that has a substantial effect on the growth rate, and the population anticipates this effect.

Now let us introduce donor money into the picture and assume the donor or multilateral offers the country an all-or-nothing deal, an α that is lower than the optimum plus an L (the loan or grant), or nothing. The government therefore has to choose between:

$$U1 = \alpha(t) \; GDP + \alpha(t+1) \; p \; g \; GDP; \text{ and}$$
$$U2 = \beta(t) \; GDP + \beta(t+1) \; q \; n \; GDP + \beta(t+1) \; L$$

where $\alpha > \beta$; $q > p$ and $n > g$.

We know that U1 is greater than the first term of U2 (as α maximizes utility). So the basic question is if L is larger than the difference between the two. This

will be less probable, ceteris paribus, the greater the adjustment (α minus β), the lower the elasticity of g wrt α (therefore, how large is n minus g), and the lower the elasticity of p wrt g (therefore, how large is q minus p). These results indicate that the loan amount that will encourage the government to pursue an SAP will be smaller, and therefore an agreement more probable, the more effective the policy package is on growth, and the more aware the population is of the effect of the package on growth.

The period here can be defined to equal the government's tenure period (4 or 5 years), which could reasonably be argued is also the period needed for an SAP to produce benefits[2]. With this in mind, it can be seen that, ex-post, the best outcome for the government is to have U1 + L, that is, receive the money and not comply with the conditionality. However, the essence of conditionality is that L will only be disbursed if in period one the rate of rent extraction is lowered from α to β. In this model the government will not adopt an SAP[3] out of its own initiative. Only the offer of aid induces the government to adopt an SAP. However, if the money is given up front and there is no marginal relationship between the amount and performance, then the incentives faced by the government do not change and the incentives are to promise reform, to receive the money and then not to comply with the program. This is the behavior that we are observing in several countries. From the point of view of the donors, this leads to the need for monitoring and, in particular, for a marginal relationship between accomplishment of the program and the amount of money disbursed. Nevertheless, even if the loan is only disbursed at the end of period one, assuring a RER of β, the incentives to sustain the program disappear, and in the second period the government will wish to increase the RER back to α. So, in this case the government will produce the intermediate case:

$$U3 = \beta(t) \text{ GDP} + \alpha(t+1) \text{ q n GDP} + \alpha(t+1) \text{ L}$$

This predictable break with the SAP will lower the investment rate, decrease the effect on growth of the program and make it less probable that the SAP will be adopted in the first place for a given loan amount (alternatively, a higher loan will be needed for a given size of adjustment). The only way to prevent this break is to make the donor agency a long-term partner of the country, promising a flow of disbursements into the future on condition that the SAP continues. Then there is no end-period problem since the flow of loans keeps the incentives in place to sustain the SAP. However, for this to be possible, the marginal

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[2] See Solimano (1992) for evidence supporting this lag.
[3] Barring exogenous shocks which lower the growth rate and consequently lower the optimal α.

relationship established imposes a kind of 'extreme' conditionality. Every step back has to be penalized and every step forward has to be rewarded.

If L is made a function of α, the government is faced with the following problem. We now assume that α is set sequentially by a government, evaluating its chances of reelection. If it is reelected, it performs the same maximization, and so on. We explicitly assume that $\alpha(t)$ and $\alpha(t+1)$ can be different, relaxing a restriction imposed to the maximizations solved above.

$$\max \ \alpha(t) \ GDP + p \ \alpha(t+1) \ GDP \ g + \alpha(t) \ s \ (\alpha(t)) \ GDP + \alpha(t) \ \alpha(t+1) \ \alpha(t+1) \ s \ (\alpha(t+1)) \ p \ g \ GDP$$

Here s=L/GDP (i.e., the size of the loan in relation to GDP), and s'(α) is negative. The FOC now says that the more sensitive s is to α, then the higher the rate of growth[4]:

$$\alpha(t) = -\{(1+s)[1 + \alpha(t+1) \ (p' \ g + p \ g')]\}/s'$$

With the marginal relationship, it becomes a self enforcing contract, in which it is in the interest of the government to implement the SAP. If there is no marginal relationship then the loan will not produce any additional pressure to follow a program different to what is privately optimal for the government. With this marginal relationship, the optimal RER is lower, and the growth rate higher, and they will be lower and higher, respectively, the more responsive the loan amount is to performance.

Now, it could be argued that at some point the country 'graduates', the process of structural adjustment ends, and the country does not face the perspective of positive transfers from the donors anymore. Will the government reverse the structural reforms?. The end-period problem would continue to exist and could make it impossible for an SAP sustained by donors to be credible.

However, this is too pessimistic. In part it is due to the simplicity of the model. In a model with two sectors (tradable and non-tradable), the openness of the economy parameterizes the FOC, and it can be proven that with certain credible assumptions the optimal rent-extracting rate is lower in a more open economy (because the elasticity of output to rent-extracting is higher in the tradable sector). Moreover, an SAP that is sufficiently well designed and is carried through to an advanced stage will break the groups that were favored by the old policies (like import substitution) and will create new groups that will have an interest in the continuation of the new policy (exporters).

[4] The form of the FOC changes substantially given that the RER in both periods can differ.

Yet the disinvestment that is implied in the disappearance of the first group and the investment implied in the appearance of the second depends crucially on the belief by private investors that policies will continue. The perverse incentives that we have just pointed out: first not to follow through with the reforms and then to reverse them as soon as donor money dries up, will diminish investment if the uncertainty is not cleared. There is a curious circularity in this argument. The system has one stable equilibrium at a low rate of growth, and incentives are to go back to the old policies unless the private sector believes that these incentives will be restrained for a sufficiently long period of time. If they believe they will be restrained, they will invest, therefore changing the structure of the economy and the optimal rent-seeking policy.

How can an investor be assured that policies will not be reversed. The assurances in this area are given by: a) the quality of the team implementing the reforms (more on this later), b) the incentives built into the contract with the donors, c) the length of the commitment of the donors to the country, and d) the more aware the population is (in a democracy) of the consequences of a reversal on the growth rate. We presume that rent-seeking governments will never be committed to the program; consequently, this variable (commitment) does not enter into the decision making process of investors. In these cases a solution is only possible in the presence of donors (again, barring exogenous shocks).

The empirical relevance of the rent-seeking government case becomes clear when one realizes that some countries have been in structural reform for decades. If the private sector has rational expectations about the motivations of a rent-seeking government when entering a structural reform process, it will see that it is in the nature of that process (according to this very simple model) that it will eventually be reversed, and that a period of inherent uncertainty on the rules of the game will follow. In this context, it is not surprising that one of the effects of structural adjustment loans (SALs) is to lower private investment. This means that the effect of an SAL on growth is lower (in the case of a rent-seeking government where these uncertainties are present) than what is usually presumed. This, in turn, by itself increases the probability of a reversal in our simple model, by diminishing the elasticity of g with respect to α. It also increases the amount of the loan that will be needed to convince the government to pursue an SAP. This result is in the line of Barro and Gordon (1983) in which, unless the government can commit itself from the beginning to a rule, the equilibrium inflation rate will be higher than optimal. In this case, unless the government in some way gives up its discretionary power to change policies, the equilibrium growth rate will be lower than optimal. In this model the contract signaling this rule (i.e., that the SAP will be pursued for enough time to make a reversal non-optimal) is signed with the donor community. Consequently, this makes it

rational for committed governments to seek the backing of the donor community to signal such commitment.

Let me now analyze the importance of the quality of the economic team, point a) above, which unlike b), c) and d), is not justified by the model presented above. It has been mentioned that a key to the sustainability of the SAP is the responsiveness of the growth rate to the program. A high quality program will receive more (and quicker) support form private sector investors. When can we expect high quality programs and how can investors say that given the particular situation of a country a certain program *is* of high quality?

3. ON THE INTERACTION BETWEEN TECHNOCRATS AND POLITICIANS

Many times we have been faced with economists complaining that politicians do not pay attention to their advice. We know that both groups face different constraints and therefore this is not surprising. However, given the obvious point that the degree of success of an SAP will depend on the quality of the advice actually put into practice and the quality of such advice, we need to look further into the interaction of technocrats and politicians to determine when and how advice will be accepted. Let me use one example to illustrate this issue: the decision on by how much to adjust fiscal policy up-front (insufficient up-front adjustment has up to now foundered many SAPs).

A key issue in the discussion of fiscal policy in structural adjustment is the proper sequencing of stabilization (for which fiscal adjustment is a key element) and liberalization (or structural reforms). In theory, there is a 'correct' sequence. But not everybody agrees with this theory. We will work with four technocrat's positions with respect to this theory and its implementation.

The four 'archetypical' positions in this respect are: a) that of the theorist, b) that of the 'stubborn' theorist (as a relevant sub-case), c) that of the practitioner, and d) that of the cynic. These perceptions underlie three interpretations of why SAPs go wrong, that is, respectively: (i) either the theory is applied incorrectly or there is a problem in implementation, (ii) either the theory is impossible to apply or is incorrect, and (iii) the country does not make any effort to apply the theory.

The practical consequences of the above positions are very different. If the theorist is right, then it is a matter of applying the theory correctly. If the practitioner is right, then what is the received wisdom cannot be applied, or is wrong and the theory should be changed. Finally, the cynic would say that all this exercise is irrelevant as countries do not follow any particular theory. The cynic would say that it is not a problem of implementation nor of the theory behind the

SAPs, but of the lack of incentives to apply the theory and to follow the steps in the spirit of the theory. It is these incentives that would have to be changed for the SAPs to perform better.

To set up the discussion, we will start by a brief outline of the rationale behind SAPs and the theory behind fiscal conditionality. From here we will adopt a position that we will consider 'Existing Theory' on the subject for the rest of the study. In this study, given the importance of fiscal adjustment for stabilization, we will not make a difference between one and the other. This identification of fiscal adjustment and stabilization is only done for expository purposes.

4. THE SEQUENCING OF STABILIZATION AND LIBERALIZATION

The theory exposed below is taken from several World Bank studies or Bank commissioned studies on SALs. I am specially concerned here with the place that fiscal conditionality should have in structural adjustment. According to Selowsky (1990), Corbo and Fischer (1990) and others, the process of structural adjustment should start with stabilization, followed by trade and price liberalization, followed by financial liberalization and institutional changes. There are strong arguments in favor of this sequencing. The most important practical conclusion of this argument is that a different sequence could actually hurt the economy, rather than help it. Sequencing, therefore, is a key element of the quality of the reform program.

The emphasis on stabilization as a first stage of the reform process is the first point of conflict between the theorist and the practitioner. In practice, to put all the stabilization process up front may mean to abort the whole process, as a country may not want to take all the measures needed for stabilization (e.g. instead of lowering the fiscal deficit from 8 percent to 2 percent of GDP, it would rather lower it to 5 percent). But it may want to do some liberalization instead. In theory, this may not be enough. The deficit would have to be lowered to a reasonable level before liberalization is attempted: enough stabilization so that liberalization can go ahead without causing any damage. Consequently, the theorist may oppose a plan that has insufficient up-front stabilization as actually producing more damage than good. The practitioner takes a different approach: we know that trade liberalization is good for an economy; therefore, why should we not be advancing in this area? The country is willing to do the full stabilization process in the long run (e.g., lowering the fiscal deficit from 8 percent to 2 percent of GDP in four years), and this step will have the country better prepared for growth after stabilization is concluded. That is, why should we forgo the opportunity to advance in trade liberalization just because the country does not take 100 percent of the measures needed for stabilization? Now,

if the 'Existing Theory' is correct, to do only a part of the stabilization up-front will hurt rather than help the economy. The cynic believes the country will not apply any theory at all, but do whatever is needed to get both the outside money and the votes.

The fourth position (the 'stubborn' theorist) is that only stabilization is important and should be attained, even at the risk of reversing liberalization. This is an extreme version of the theorist's position as we will see.

With the latter, we have three positions (excluding the cynic's non-position) on the importance of stabilization and its sequencing within the adjustment process. All three will be characterized by a country indifference curve (resulting from a welfare function) in the stabilization/liberalization space, an indifference curve that would tell us in each case which combinations of both would leave the country at the same level of welfare (see figure 1). The first position (curve B) states that stabilization should precede liberalization. In this case the indifference curve could be described as concave up to a point and then a horizontal line: up to some point there is a trade-off between liberalization and stabilization (more liberalization at the cost of less stabilization leaves the country at a same level of welfare), but below certain stabilization threshold (point D), to liberalize more and stabilize less unambiguously leaves the country worse off. Therefore, the indifference curve flattens and there is no more trade-off. In other words, more liberalization without more stabilization can be counterproductive. This is what we consider to be 'Existing Theory'. The second position (the practitioner, curve A in figure 1) maintains that more liberalization can be traded for less stabilization (a continuous trade-off exists between the two, consequently the 'theory' is wrong). Finally, the 'stubborn' theorist's position says that stabilization should be obtained first at all costs, even at the cost of less liberalization[5]. This is a variant of the first position, in which the indifference curves are different: for the third position, the relative value of stabilization is much higher (and therefore the indifference curve -with stabilization on the vertical axis- is flatter) and the threshold at which liberalization becomes an 'economic bad' is much higher (see curve C).

Operational Consequences

The positions described above have different operational consequences. They are adopted by the 'technocrats' in a government and taken to the negotiating table with the 'politicians'. We will here take the politicians position as given[6],

[5] For example, increasing tariffs to reduce the fiscal deficit.
[6] We will consider this position to be that both stabilization and liberalization are 'economic bads' for politicians, and that they value the political costs of stabilization higher than those of liberalization. This will be justified below.

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and try to draw some conclusions on how the above three positions affect the
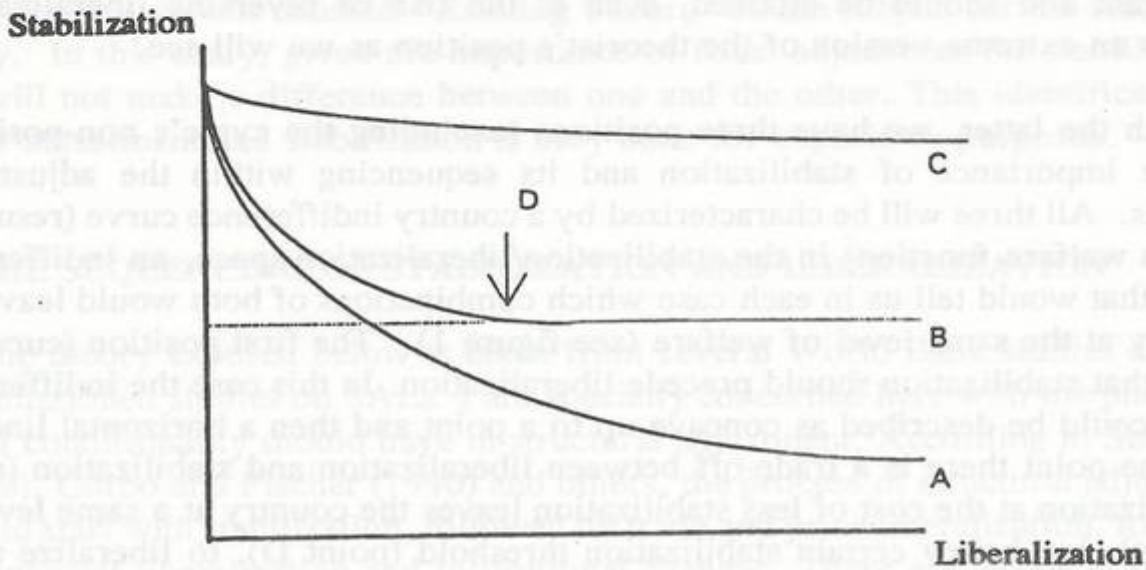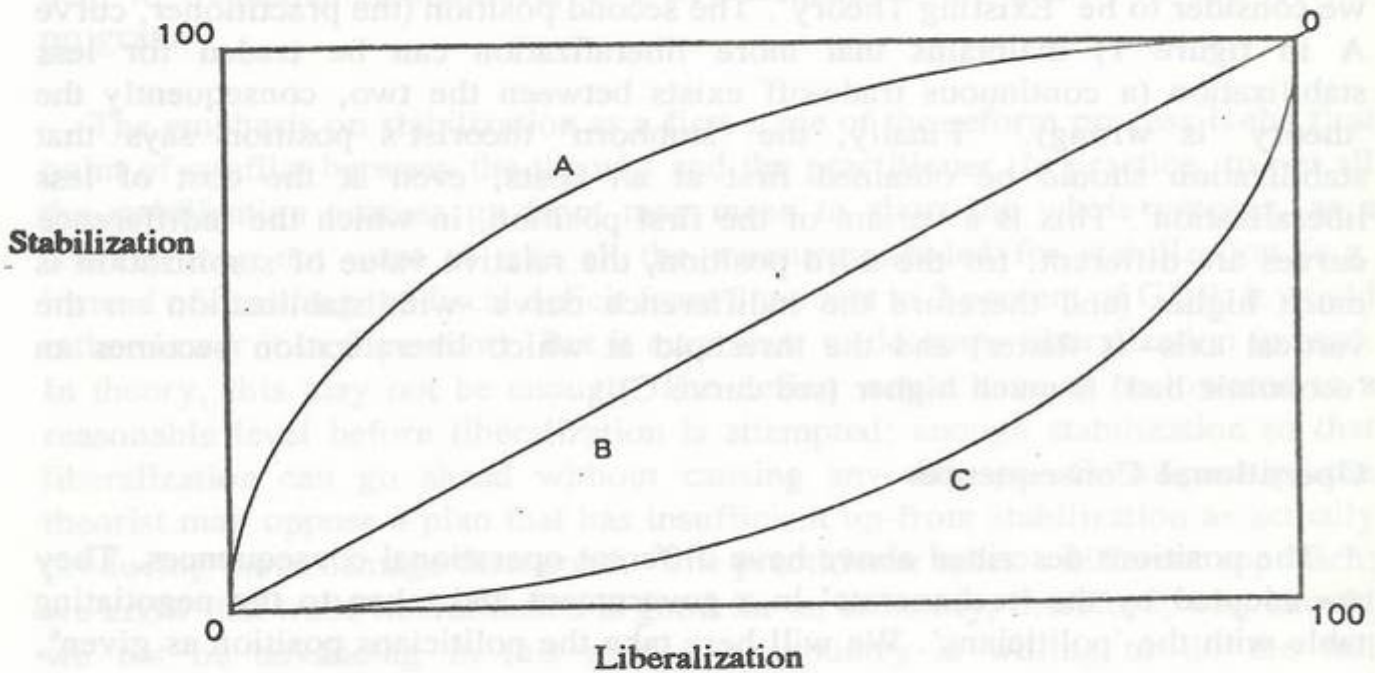policy outcome.

FIGURE 1

FIGURE 2

As shown in Figure 1, the three positions described above can be described by
alternative sets of indifference curves in the stabilization/liberalization space
(going from 0 to 100 percent, for example). These curves can be combined with
the politicians' indifference curve to form three contract curves (figure 2).

What will the politicians' indifference curves look like? Countries do not perform structural reforms because the payoff is too far in the future[7]. Politicians view SAPs as a cost since it implies deviating from the optimal rent-extracting policy (from their own point of view). We are, therefore, faced with two actors with different attitudes towards reform. In this context, we can interpret the stabilization/liberalization space as an Edgeworth box (in which the 0,0 point is the origin for the technocrats, and the 100,100 is the origin for the politicians), and identify a contract line. The three positions described above, end up on different contract lines for any given utility function for the country. The tangency between the three indifference curves and the country's indifference curves determine the points on the contract curves. The points of tangency of the theorist and the practitioner will only differ if we assume that the government has a relative preference for liberalization over stabilization, and therefore countries always end up in a corner solution (in point D) when faced with the 'theorist's' indifference curve B (at the lowest acceptable stabilization level). If the converse is true (and countries may vary on the issue), then there would be no difference between the theorist's and the practitioner's contract curve. Therefore, our discussion is mostly relevant for those countries that are relatively most unwilling to stabilize. This surely makes the analysis still applicable for most of Latin America.

The three contract lines are such that, independently of the preferences of the politicians, the third group of technocrats will end up with more stabilization and less liberalization (contract curve A in figure 2); the position that there is a continuous trade-off between liberalization and stabilization ends up with the least stabilization and most liberalization (contract curve C), and the theorist ends up with an intermediate contract curve (B). This does not mean that the third group of technocrats will always get less liberalization, because we have only described the contract curves, not the final equilibrium point, that depend on the relative negotiating strength of the parties involved.

The practical consequence is that, if the 'Existing Theory' is correct, then any technocrat, save for the extreme stabilizers, may end up with an inappropriate mix or sequencing of policies, with too little stabilization and, consequently, the package will backfire, and the SAP will be abandoned. Therefore, it is not surprising that the most successful technocrats are the most orthodox (Chile, Mexico). Obviously, in the latter cases it helps that the horizon was longer than usual.

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[7] In this context, the donors' loans/grants permit the country to enjoy a higher level of consumption today, and so solve an intertemporal conflict in incentives. Or, better still, it permits the private value of reforms to reflect their social value. In other words, donors are characterized as some kind of international government, intervening to solve intertemporal externalities produced by the finite life of governments.

We will not address the topic of what gives technocrats more bargaining power over politicians, but one could speculate that lack of financing, loss of control over policy variables, hyperinflation, sharp decrease in terms of trade, etc., would enhance their negotiating power and consequently improve the quality of the package.

Which of the positions we have described will be defended by the technocrats of a certain country is not arbitrary. The government picks advisors that are closer to the political party in power. If the analysis above is correct, investors would be relieved and the chances of success increased if advisors are of the 'stubborn' type. Apart from the non-trivial task of selecting advisors with the right diagnosis and recommendations, governments are benefitted from the conviction with which these advisors defend these positions. And it should be underlined that we still are thinking of an uncommitted government that views pragmatically the stabilization program as an 'economic bad'. Once they have decided to embark in an SAP, the probability of investment picking up quickly would be enhanced if the advisors 'type' guarantees that the policy package is of high quality. The advisor's type acts as a signal, and donor agencies could have a role in this signalling process. Now, it is important again to review the role of donor agencies and multilaterals in this role. If one agency acquires prestige as providing good quality advice, then the SAP's possibilities of success would be enhanced by the endorsement of such an agency.

5. CONCLUSION

In the first part of this paper we tried to answer the question of why SAPs can be reversed so rapidly. Working with a rent-seeking government, shows that compliance with an SAP is endogenous. The key issue is to study which factors can permanently alter the equilibrium rent-extracting rate. The paper identified several incentives to announce and not to implement an SAP and to reverse an SAP policy, and ventured these as a possible explanation for the low investment rates being observed in countries implementing SAPs. The paper also argues that the implementation of an SAP for a period of time long enough to produce structural changes in the economy would alter the equilibrium rent-extracting rate and consolidate the reforms. Consequently, the signaling of the endurance of the measures is a key issue in triggering investment. This time inconsistency problem that could create a low growth rate equilibrium appeared to be solved by the participation of an outside agency, that provided a self-enforcing contract and consequently a long-run commitment to the process.

The second part of the paper argued that orthodox (stubborn) theorists are the ones that are most probable generators of high quality programs. As the availability of these technocrats will depend on the human capital investment

policies of the past and of the probability of having them in the government, the possible role of donor agencies in signaling such quality is pointed out.

Both by signaling the long run commitment of the government with the program and by signaling the quality of such program, donors have an important role to fulfill in the successful achievement of an SAP, by solving the time inconsistency problem faced by rent-seeking governments. The confidence in the signaling abilities of these agencies is a free good for the countries and consequently they will try to free ride on it. If agencies relax their standards, and their signaling ability becomes questionable, they lose the ability to perform this role.

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