The Political Economy of Fiscal Policy

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PREFACE

In the early 1980s there was a great deal of discussion over the apparent difficulty economic theory was having in predicting or explaining the real-life behaviour of national economies. A different analysis of the emerging economic development crisis in the third world emphasized the political constraints that impeded the execution of fairly obviously needed economic policy reforms. The present volume was conceived as an illustration of the applicability of this analysis.

At that time fiscal policies were in disarray in both industrialized and in developing countries. In many countries there was a consensus among national economists and international observers that fiscal reforms were needed in order to achieve growth and control inflation, and yet governments and legislators were unwilling to carry out such reforms. It therefore seemed intellectually challenging to initiate a project at the United Nations University which would analyse the decision-making processes in various countries in the fiscal policy area in the hope of determining what the major barriers were to the solution of the fiscal deficit.

When the project was discussed with Professor Ichimura of Kyoto University, he found it to be quite interesting and agreed to help organize it. With his active participation and the support of Professor Yukawa of Kyoto Sangyo University, researchers in different countries were contacted and, with their participation, a joint research methodology was established at a meeting in Kyoto in 1985.

To make the case-study comparison interesting, we chose countries with different political regimes. In Latin America, for example, the countries cover a wide spectrum that ranges from democracy to a democratic one-party system to an authoritarian regime. Both countries that have had high fiscal deficits and those with more manageable ones were also chosen. Finally, we included the Philippines because, in addition to and maybe because of its Spanish heritage in common with the Latin American countries, it also seemed to have similar institutional and policy constraints. The first draft of the case-studies was presented at a meeting hosted by the East-West Center in Hawaii in 1986, and all the authors had incorporated the insights they derived from these discussions into their papers by the middle of 1987.

The present collection analyses the political constraints present in fiscal policy-making and the fiscal decision-making process in countries with different political systems. In no political system is tax reform easy or popular, but implementation is easier if the decision-making process and the relative strength of the different interest groups are better understood. It is hoped that this volume contributes to that understanding.

I would like to thank Ms. Kumiko Ishikawa of the United Nations University for all her help in the administrative management of the project and the publication of this book, as well as Ms. Noriko Hasegawa and Ms. Yoshie Sawada for their invaluable collaboration in the different stages of the project.

Miguel Urrutia
November 1987

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A CONCEPTUAL FRAMEWORK FOR THE POLITICAL ECONOMY OF POLICY-MAKING

Shinichi Ichimura

Introduction

This chapter purports to offer a conceptual framework for the study of the political economy of fiscal policy mainly in developing countries. Its main concern is not fiscal policy itself but the political and economic factors that affect the decision-making and implementation of fiscal policies. Economics and economists are usually concerned with the former; namely, what policies are appropriate in a given economic situation to attain certain policy objectives, such as economic growth, full employment, price stability, or redistribution of income and wealth. But adopted policies are often not the policies that economists recommend as the best or even the second best. The main reasons are that policies are made not just on the basis of economic analysis but under the influences of non-economic social and political forces. Moreover, policies must be put into practice in a society which somehow must accommodate itself to the vested interests of various pressure or special interest groups. The influence of these non-economic factors seems to be more important, or at least less transparent and non-systematic, in developing countries than in the developed countries. Recommendation of any economic policies must take into account these political and social factors and clearly state the assumptions about the responses of the social groups involved in the execution and implementation of those policies.

The political economy of fiscal policy can be studied in terms of the following three stages of policy-making, because the issues to consider are different from one stage to the other.

1. Analysis of economic situations and prescription of policies: This is the standard approach in economic textbooks, so that further exposition seems un-

necessary. There are, however, some problems not necessarily taken up in economic textbooks but important in practice in connection with political economy of fiscal policy.

2. The process of decision-making: Policies are chosen within the framework of certain institutions and their *modus operandi* while taking into account the vested interests and opinions of various pressure groups.
3. Implementation of policies: How effectively the adopted policies are implemented depends on the responses of private or public institutions and individuals to those policies and the institutions through which these policies are to be implemented.

The first stage is almost exclusively economic analysis, but it is by no means easy to prepare the appropriate policy prescription for any one developing as well as developed economy. Certain aspects of this stage which have not usually received sufficient attention in policy analysis studies will be discussed in the following section. As for the second and third stages, a few additional concepts and new approaches to policy-making and policy implementation are required. These new approaches will be presented in the third and fifth sections, taking examples mainly from Japanese and some other Asian countries' experiences. Since the institutions and situations in which fiscal policies must be practised or implemented will be very different from one country to another, the concrete case-studies and related observations presented here should be considered as mere examples. The more specific analyses and observations are to be found in the individual country studies in the following chapters.

One basic point in analysing the problem of policy-making is to see (1) who participates in the decision-making and (2) how much freedom is allowed in decision-making.

On the one hand, if no one other than the president or the prime minister and his inner circles participate in making a particular decision, it may be said that the head of state has "non-participatory hegemony" or "closed hegemony" so far as that decision is concerned. If almost all the decisions are made in a similar fashion, then such decision-making may be called "dictatorial." On the other hand, if the choice of policies and decisions is left to market forces or any other liberal decision-making methods with no intervention of the government or any other authorities, then it may be said that there is "freedom to choose," or such decisions may be called "liberal decisions." In real society there is no perfect freedom to choose in many decisions. There are many government regulations, and one often needs the government's permission to undertake various economic activities. In this aspect of liberal or restricted decision-making, a distinction may be made between economic decisions such as pricing and political decisions such as freedom of expression, freedom of the press, or freedom of association. There are two dimensions, therefore, to differentiate the types of decision-making in the sense of political economy. Figure 1 is meant to show the ways of differentiation in a simplified manner.

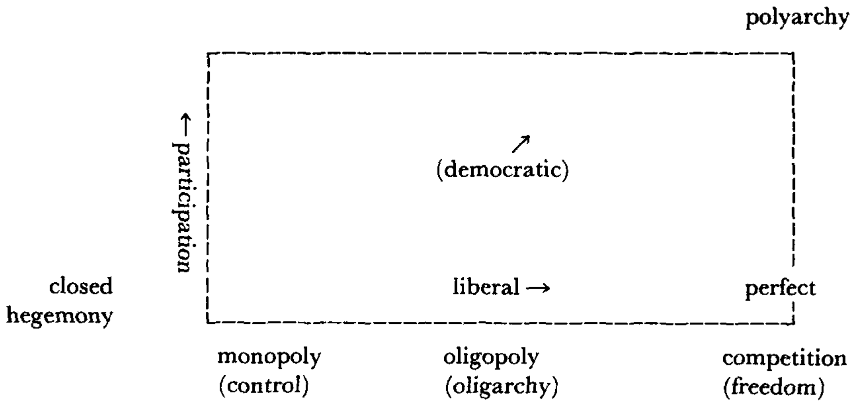

FIG. 1. Dimensions of political aspects of policy-making

In relation to the market mechanism, the most hegemonistic form of decision-making is the case of monopoly, whereas the most liberal one is that of free competition. In between there is oligopoly, or workable competition. In this context industrial organization in each national economy is very important. A distinction between "centralized decision-making" and "decentralized decision-making" is an important aspect of political decision-making, but it can be applied to economic decision-making as well. Oligarchy is a style of decision-making that falls in between.

Another aspect of decision-making concerns "liberalism" versus "control." In many developing countries freedom of the press, freedom of expression, or freedom of association is much more restricted than in developed democratic countries. The degree of control or liberty differs from one country to another. It does not necessarily correspond to the level of per capita income, which may be taken as the best index of economic development. Some sociologists and political scientists introduce as points of reference the concepts of social development and political development. However, since the intertemporal processes of social or political development are not as clear as economic development, there is no acceptable indicator comparable to per capita income as an index for economic development. Since some countries may be developed in the economic sphere but not so well developed in the social and political spheres in that certain freedoms have not been realized, the use of such concepts as political or social "development" is better avoided, at least in the context of the discussions here. Nevertheless, it is important to distinguish the two styles of decision-making, liberal and controlled, in the following discussion on the political economy of fiscal policy.

Once some degree of decentralized or liberal decisions is permitted, it is unavoidable that many individuals and social groups will try to obtain special privileges by negotiating with the authorities, to be exempt from certain restric-

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tions, for instance, or to obtain special permits exclusive to them. Much political influence will be exercised one way or another for these purposes. Even if liberal decisions are somewhat restricted, there normally emerges some degree of "contestation." Non-liberal decisions are the ones which usually ignore contestation from private citizens.

There are correlations between these two aspects, participation and liberty, in the process of policy-making. The more participation is permitted, the more contestation is likely to be made. "Dictatorial decision-making" has no participation and little liberal contestation. "Polyarchy" is decision-making with sufficient participation and liberal contestation. The many variations of the political decision-making system found in developing countries are somewhere between these two systems. In most developed countries the political systems are characterized by "polyarchy." In most Asian countries the political system in which economic policies are prepared and implemented is often called "authoritarian." The authoritarian system in Asia, as distinguished from the dictatorial one, may be interpreted as one that allows some degree of formal and informal participation of technocratic bureaucrats and businessmen in policy-making and their liberal deliberation of opinions and influences. How they are involved in decision-making will be discussed in later sections.

The Structure of the National Economy and Fiscal Policies and Objectives

A national economy has a certain structure which cannot be changed in the short run. Many short-term fiscal and other policies must be implemented within the structure as given. The structure could embrace many things, such as industrial composition, trade relations with foreign countries, economic laws and regulations, institutions, etc. Some aspects of this structure are clearly formulated in terms of an econometric model, containing many variables, behavioural equations of economic entities, and accounting or definitional identities. Other, important aspects of the structure of the national economy are, however, usually not included in an ordinary macro-econometric model. For instance, the characteristics of industrial organization of a national economy are usually outside the scope of standard macro-econometric models. Needless to say, they are very important in policy-making in any national economy. Some aspects of economic structure are not even suitable for modelling. Nevertheless, modelling is practically the only way to make clear the logic, consistency, and quantitative assessment of economic policies. This does not mean, however, that it is always necessary to have models for all policy analyses.

What is essential in policy analysis is an understanding of the interdependent relations among various economic variables or economic entities and their behaviour that compares with that afforded by an econometric model. This interdependence includes international as well as domestic relations. Every national economy is now a part of an interdependent world and a country seldom has free hands in handling its own economic problems. Besides modelling and an awareness of interdependent relations, there are a few points which must be kept in mind in policy analysis, particularly for developing countries.

First, the development stage of a national economy must be clearly pinpointed in one way or another. The structure changes from one stage of development to another. As Colin Clark, Simon Kuznets, and other economists have discussed, the industrial composition of GDP and the composition of manufacturing industries, for example, change rapidly as per capita GDP goes up. The relative weight of the primary sector will decline, and the relative importance among manufacturing industries will shift from light industry to heavy/chemical industry, from labour-intensive to capital- or technology-intensive industries and, further, to service industries.

Another important aspect of the structure of the national economy is the relative share of the public sector *vis-à-vis* the private sector. In most developing countries the weight of the public sector, including government enterprises, is surprisingly large, even in the non-socialist countries. The relative weight in each country depends very much on its historical background. In Indonesia almost all the large, indigenous corporations are government enterprises, having been inherited from the colonial Dutch East Indies. The same is true with Malaysia, the Philippines, Thailand, and even Singapore. This condition of large public ownership versus small private ownership has not changed since the end of World War II. Recently in many developing countries, as well as developed countries, privatization has become almost a vogue because the inefficiency of public enterprises has been universally recognized. This aspect is very important when the effects and effectiveness of economic policies are to be analysed and assessed.

Third, the policy measures or instruments must be considered and chosen out of a wide range of means in the policy basket. There are many potential policy measures that have not been used in the past and yet may be found useful in the future. This consideration seems to be particularly important in developing countries, where past experiences are limited.

Fourth, even the institutional framework may be changed within a reasonable time. For example, the rate of foreign exchange has been almost fixed *vis-à-vis* US dollars in most developing Asian countries, but this regime could be changed all of a sudden. The regulations on foreign investment or banking activities in developing Asian countries have changed a great deal in recent years. These institutional changes—the change in the banking law in Indonesia in 1984 is a case in point—should not be excluded from the list of policy measures. Liberalization of various restrictions imposed by the government upon private corporations is another example of such policies which have been taken up in many countries in recent years. But at the same time import restrictions are still imposed afresh from time to time in some countries. Institutional changes may include permitting ownership of some assets, such as land, by foreigners or joint ventures and the privatization of government enterprises. In many developing countries in Asia institutional changes are very important in considering economic policies. A number of measures in the fields of trade policy, taxation, subsidies, permission policy, industrial and monetary policy are related more or less to institutional or regulatory changes.

Fifth, in order to prescribe desirable policy measures, it is important that the objectives of economic policies be clearly stated, because the effectiveness of fiscal policies must be assessed in the light of these objectives. They may be defined in terms of one variable, such as per capita GDP, or in terms of a combination of certain variables. The so-called social welfare function is an example of the latter. In many developing countries in Asia, the preparation of five-year economic development plans has become an important political event, sometimes related to the presidential election. These economic plans usually state the objectives of maintaining a certan desirable rate of economic growth while keeping the inflation rate down below a certain percentage and containing the deterioration of income distribution within a reasonable range.

Sometimes the purpose of economic policies is the maximizing or minimizing of some kind of objective function, although it is seldom rigorously formulated. Often, however, objectives may be given in terms of a certain set of targets to attain; for example, a particular level of per capita GNP and percentage shares of various industries in the GDP in some future year. It is also possible to give objectives in terms of certain inequalities or specified ratios. If income distribution, savings ratio, capital output ratio, capital labour ratio, or government deficit are the main concerns of policy makers, then specifying the targets or objectives is quite sensible.

Sixth, in the case of developing countries it is not unusual to attach considerable importance also to certain political objectives, such as maintaining national unification or national independence in the sense of ensuring freedom from the domination of foreign capital in industrialization or from the influence of former colonial powers. Sometimes nationalistic sentiment requires a "monument" to symbolize the economic development of the nation. It was for this reason that steel mills were constructed by so many developing countries and that nowadays, manufacturing industries such as automobiles are promoted by some Asian countries. When this kind of political objective is put forth, all economists can offer is a clarification of the costs and benefits of implementing such policies.

Seventh, among these economic and political objectives, it may be sensible to distinguish three kinds of objectives with reference to a time horizon; namely, long-term, medium-term, and short-term objectives. Typically, a short-term objective is price stabilization, a medium-term objective is to reduce unemployment, and a long-term objective is to attain a high per capita income with national security. In terms of the length of period, short term usually means within a few years; medium term means around 5 to 7 years; and long term means usually beyond 10 years to 20 or 30 years. These periods correspond approximately to Schumpeter's three business cycles or waves. To the extent that the national economy is exposed to business cycles, the position of the national economy in the phases of business cycles is relevant in choosing and implementing economic policies. As was mentioned above, any national economy is interdependent with the world economy, so that the more dependent on foreign trade and the more open the national economy is, the more susceptible it will be to the outside influence of business cycles in the leading economies.

More fundamentally, however, this periodic distinction is meaningful with regard to the achievement of specific objectives of certain types of economic policies. For instance, the construction of a large infrastructure or capital investment require a knowledge of the long-term prospects of the national economy. No matter how serious unemployment or underemployment situations may be, they cannot be relieved in a few years, so that the medium-term policies have to be prepared toward such longer-term objectives. Examples from Japan may be of interest. One of the long-term objectives of the Japanese nation in the Meiji period (1868–1912) was "Rich Nation, Strong Army"; one medium-term objective was to attain "Self-Sufficiency of Food and Industrialization." To these ends the government made an extra effort to develop agricultural technology and to expand the irrigated area to be able to grow rice even in the northern regions. Industrialization was urged not only to increase exports beyond such primary products as silk, tea, or silver of the early Meiji period but also to create a strong military. The short-term objectives were set more concretely for specific purposes such as developing the textile industry or price stability.

In the study of the political economy of fiscal policy in contemporary LDCs (less-developed countries) it is important to identify the officially stated objectives of each nation's policies in their time horizons and to examine the extent to which they are attained in practice. This is an obvious way of ascertaining the real rationale of policy-making in each country. There are mutual relations among these short- , medium- , and long-term objectives. Usually the short-term objectives are intended to prepare the national economy for certain, expected circumstances and to avoid undesirable consequences while satisfying the medium-term objectives. The medium-term objectives are, in turn, derived from the long-term objectives with a view to considering the domestic and international situations likely to bear on the economy in the near future. The long-term objectives are determined in close connection with the political objectives of nation building, particularly in developing countries. All of the objectives have greater or lesser political implications, but the longer the periods of relevance are, the more political the implications of the objectives of economic policies are likely to become. It is important to see if the policy objectives of each national economy are set appropriately for its stage of development and the international situation.

The relations among the three levels of objectives are not always consistent if there is not careful co-ordination. For instance, policies aimed at rapid industrialization may contradict the objective of preserving a clean, safe environment. The same kind of contradiction or trade-off in relations may appear if different objectives are maintained for the same period. It may become necessary, therefore, to prioritize the objectives of the three periods as well as those in the same period. It seems that such considerations are even more important when the objectives affect non-economic international relations. For instance, a typical slogan relating to medium-term economic policies in post-war Japan was "Prosperity through Exports, Stability through Saving." This promotion of exports has become contradictory with Japan's long-term objectives of maintaining friendly international relations with almost all the nations in the world, particularly the United States and Japan's Asian neighbours. A study of the political economy of fiscal policy must examine how each country was able to overcome such contradictions or trade-offs among the different objectives and what kinds of policy measures were or were not taken to resolve them.

Eighth, in these studies attention must be paid not only to the effects of policies *vis-à-vis* the objectives but also the speed with which the effects are realized. For the political impacts are often related not just to the effects but the time allowed for the opponents or the affected to adjust themselves to the effects. Japanese economic advancement is often causing troubles owing to its "unexpected, concentrated downpour" export expansion. Clearly the question here is one of an intertemporal co-ordination of the speed in attaining the objectives. Policies must be chosen in favour of attaining the long-term objectives rather than the short- or medium-term objectives if a final choice has to be made. It is highly desirable, therefore, to carefully analyse the interrelations between various policy measures and the three levels of objectives. For this purpose the structure of a national economy must be clearly understood relative not only to its own characteristics but also to its international linkages.

The Process of Decision-making

The academic discussion of economic policies is one thing, the actual determination of government policies is quite another. In order to see what policies are actually adopted by government authorities, one needs to carefully observe the process of policy-making in each country. In addition, it is important to observe how these policies are implemented, because the adopted policies are often further modified in the process of implementation. This latter aspect will be discussed in the section on the implementation process below.

Who participates in decision-making, what policies are decided upon, and how decisions are made are the kinds of questions that must be answered and they are taken up in this section. Generally speaking, decision-making on important policies in any market economy has five major participants: (1) bureaucrats; (2) political parties; (3) pressure or special interest groups; (4) government ministers; and (5) the head of state.

Even in Japan, where "consensus" is regarded as the prevailing pattern in reaching a decision, these five participants check each other and keep a certain balance among themselves. The five major participants in Japan may be specified as follows:

1. government bureaucrats (GB);
2. the Liberal Democratic party (LDP);
3. special interest groups (SIG);
4. government ministers (GM); and
5. the prime minister (PM).

The first three seem to effect a check-and-balance mechanism before policy issues are brought up to the ministerial levels and the Cabinet meeting, where final decisions are made under the chairmanship of the prime minister. Needless to say, the ministers and the prime minister can exert their influences directly on the bureaucrats and political parties while they are discussing the issues and policy recommendations.

Checks and balances among the first three participants work as follows. SIG can influence the LDP by controlling their contributions to the financial resources of the party or its factions as well as the number of votes supporting the party; the LDP can control GB primarily through personnel administration in government offices, claiming to represent the electorate's wishes. Finally, GB can influence the LDP and SIG by offering or refusing to provide them with the expert knowledge, advice, necessary information, or efficient execution of relevant policies. Needless to say, SIG, or pressure groups, are not necessarily big business groups only. They may be labour unions, farmers co-operatives, the associations of small and medium enterprises, consumers co-operatives, and so on. How these pressure groups are organized and can exert influence on economic policies will be discussed further in the next section.

A standard way of starting the decision-making process is to have a common understanding among the three participants of the need for making a decision on some specific problem. The need must be recognized by all the participants. The so-called consensus in Japan is particularly efficient in this stage of recognition of the need of taking action on some problem. The process is impeded by any one participant's disagreement if consensus is required before starting the process of decision-making. The way of reaching this consensus may be schematized as in figure 2.

The matter of who takes the initiative in raising a question on some problem depends on the problems and situations. Many international problems come to

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