

Supporting Policy Reform From the Outside

Insights From a Theoretical Framework

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Country Department Caribbean
Group

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Abstract

Policies are not designed and implemented by a social planner but are determined through a political process, based on the policymakers' preferences, beliefs and the constraints provided by political institutions. The resulting outcome could entail the choice of inefficient policies. This study presents a modified version of Besley and Persson (2011)'s core model which explains policy failure as the result of weak political institutions, negative views vis-a-vis public goods and/or limited technical capacity for identifying and designing high-quality public programs. In light of these theoretical predictions, the limits and opportunities are discussed for external agents to support policy reform processes in recipient countries.

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Abbreviations and Acronyms

IDB	Inter-American Development Bank
IFI	International Financial Institution
LAC	Latin-America and the Caribbean
PBL	Policy-Based Lending
RCT	Randomized Controlled Trial
SG	Sovereign-guaranteed

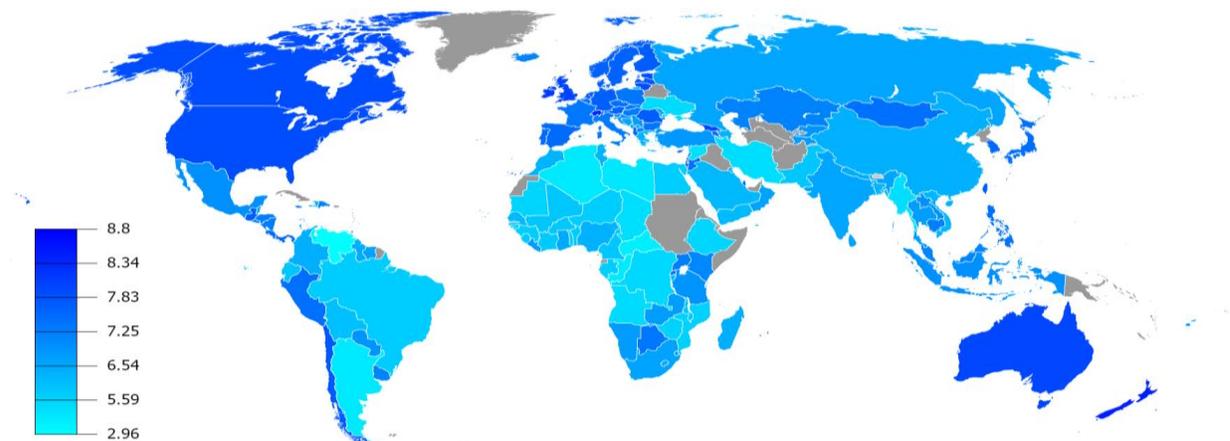
1. Introduction

Sound economic and social policies are important if countries wish to prosper and achieve sustainable development.¹ Public policies are needed to provide public goods, address externalities, aim for equitable redistribution and support a good functioning of the economy. It is far from guaranteed, however, that good policies arise in equilibrium.

Figure 1 illustrates for the year 2015 the quality of the policy framework for a large set of countries. It is based on the Fraser Institute's Economic Freedom of the World Index, which measures the degree to which the policies and institutions of countries are supportive of economic development. Scores range from 1 to 10. Figure 1 shows that considerable variation exists in the quality of policies countries end up with. In 2015, Venezuela was ranked at the bottom with a score of 2.96 while Hong Kong topped the list with a score of 8.95.

Taking a regional perspective, Western countries have the highest average policy rating (7.68), while Sub-Saharan Africa scores the lowest with an average policy quality of 6.22. With a mean score of 6.68, Latin America and the Caribbean (LAC) come behind the West, Eastern Europe and Central Asia (7.13) and East Asia and the Pacific (7.06). It is important to note that within LAC considerable variation exist, actually the highest among all regions. For instance, Chile's policy rating is 7.79, which is higher than the Western average, while Argentina's was only 4.88 in 2015. The Caribbean countries – i.e., Bahamas, Barbados, Guyana, Jamaica, Suriname and Trinidad and Tobago – perform slightly better than the Latin American ones (6.79 vs. 6.65).

Figure 1: Quality of the policy and institutional framework, 2015



Source: Fraser Institute

How can we explain the large differences in the quality of policies countries end up with? Much of the scientific literature points to government inefficiencies to explain the observed policy variation and the existence of inefficient policies.² That is, policy measures are not designed and implemented by a welfare-maximizing planner but determined through a political process, based

¹ Several studies have demonstrated the positive effects of public policies on growth and development. For example, Knack and Keefer (1995) show that strong contract enforceability and low risk of expropriation enhances investment and economic growth. Sachs and Warner (1995) report that integration into the global economy leads to convergent rates of growth, while averting balance-of-payments crises. Barro (1991) presents empirical evidence that growth is negatively related to high government consumption. With regards to inflation control, Fischer (1993) demonstrates that keeping inflation sufficiently low is conducive to sustained economic growth. Burnside and Dollar (2000) report evidence of a strong association between economic growth and a policy index that includes budget surplus, inflation, and openness to trade.

² See Besley and Persson (2011) for a recent overview of the literature on the political economics of development.

on the policy makers' preferences, beliefs and the constraints provided by political institutions (North and Knight, 1997).³ As such, there is no guarantee that efficient policies will be chosen in equilibrium. What is more, distortionary policies may be deliberately chosen as the outcome of a political process. In this study, I present a modified version of Besley and Persson (2011)'s core model, a framework that helps explain the origins of state ineffectiveness and the reasons why governments choose non-optimal policies. In light of the theoretical predictions, I briefly discuss the ways for external agents to support policy reform, focusing on conditional financing, policy dialogue, evidence and supporting changes in political institutions.

2. The Determinants of Policy Choice: Theoretical Framework

In their groundbreaking book, Besley and Persson (2011) unravel the web of causal mechanisms that makes countries prosper and develop. They present a series of models that help explain the clustering of state capacity, political violence and income. For the purpose of this study, I present a slightly modified version of their core model, which is based on Besley and Persson (2009) and Besley and Persson (2011b). The basic structure of the model involves two periods and two groups of individuals, of which one holds power in period 1. The incumbent group, I_1 , chooses policy, i.e., spending on public goods and/or private transfers, and decides how much to invest in fiscal capacity. Political institutions constrain the incumbent's choice set. After period 1, a political transition takes place: with a probability $1 - \gamma$ the incumbent remains in power. In period 2, policy choices are made by the period-2 incumbent group.

As mentioned above, I add two parameters of interest to the model. First, I allow the equilibrium to depend on the beliefs policy makers hold. This modification incorporates the findings from a burgeoning literature which convincingly shows that policy choices are also based on the views policymakers hold concerning the functioning of the economy and the way they learn from past experiences. For instance, in a recent paper Rodrik (2014) claims that many political economy models -- including his own earlier work -- make unstated assumptions about the ideas and world views policy makers have. He notes that

'Economic research is all about sharpening our ideas about the "right model". Actors in political economy models live in worlds where these questions have been effectively resolved. [However,] a more realistic representation may be that cognitive and other limitations force political agents to live in a world of Knightian uncertainty with respect to their understanding of causal relationships' (Rodrik, 2014, p. 193-194).

In another study, Buera et al (2011) develop a Bayesian learning model in which policy makers decide whether or not to pursue market policies based on updated beliefs concerning the growth performance of market and interventionist economies. They find that such a learning mechanism is able to explain almost all of the policy choices and a substantial fraction of the policy switches observed in the data. Interestingly, the authors also show that the evolution of beliefs -- and not redistributive concerns -- crucially explains the observed dynamics of policy adoption. Bénabou and Tirole (2006) provide another nice illustration. They show that individual beliefs shape (the demand for) redistributive policies. It is well-established that Europeans and Americans hold different views on the role of self-reliance vs. societal factors in determining income and success.

³ However, it is important to note this is not always the case. For instance, Banerjee (2012) presents a number of examples where policies emerge due to slack in the political game or accidental factors. In such a case political constraints are not necessarily binding and substantial degrees of freedom exist for welfare improving reform. Furthermore, the process of policy making is also influenced by contextual factors such as the social and cultural system in place (see, e.g., Kuran, 1995; Passarelli and Tabellini, 2017; Alesina and Guiliano, 2015).

Based on a model of imperfect will-power. Bénabou and Tirole (2006) show two types of equilibria emerge: an ‘American’ equilibrium with self-reliant beliefs and low redistribution and a ‘European’ one with more pessimistic beliefs and high redistribution. Finally, Besley et al (2011) provide evidence that more educated leaders are associated with higher growth rates, hence links cognitive characteristics of political leaders with economic and policy outcomes.

Second, Besley and Persson (2011) let the equilibrium policy choice depend on the value of public goods. Even though they do not specifically model it, the authors relate that value to a country's capacity to identify high-quality public projects. Identifying and designing public programs that work is not straightforward. It requires a thorough analysis and a deep understanding of behavior and local context. However, due to various barriers and limitations countries may lack the capacity to generate and process the information necessary to identify high-value public projects. For instance, Ndulu (1997) and Howlett (2009) note that countries, even advanced ones, often lack sufficient analytical capacity to design and execute public programs, a problem further exacerbated by human capital flight (Haque and Kim, 1995). When countries are disadvantaged in such ways, public policies are not expected to generate high returns. Consequently, policy makers will not be inclined to allocate resources to public spending. To capture these dynamics, I allow the equilibrium to depend on a country's technical capacity.

1.1 Model

Formally, the model consists of the following building blocks. Each individual of the population – which is normalized to one – has a (quasi-)linear utility function that depends on public and private goods:

$$u_s^J = (1 - \tau_s)\omega + r_s^J + \alpha_s V(g_s) \quad (1)$$

with ω income, τ_s the period s tax rate, r_s^J a transfer awarded to group J in period s , $V(g_s)$ the utility from consuming the public good and α_s the value of such good. Besley and Persson (2011) mention defense and nation-wide transfer programs such as health insurance as examples of typical public goods. Also the development benefits of free market policies have public goods characteristics and can thus be considered as a realization of $V(g_s)$. Concerning $V(\cdot)$, two cases are considered: a linear case where $V(g_s) = g_s$ and a non-stochastic case where $V(\cdot)$ is a smooth, increasing and concave function. The value, α_s , is interpreted as the demand for the public good. When $V(g_s) = g_s$, Besley and Persson (2011) assume that α_s is stochastic with a two-point distribution $\alpha_s \in \{\alpha_L, \alpha_H\}$ where $\alpha_H > 2 > \alpha_L > 1$ and $\text{Prob}[\alpha_s = \alpha_H] = \phi$. When $V(\cdot)$ is concave, α is a known parameter.

As a modification, I now allow the value of α_s to depend on the views policy makers hold vis-a-vis the public good and the country's technical capacity. For the linear case, ϕ is parameterized with ε the capacity to identify high-value public programs and β the policy makers' views.⁴ The reduced form equation is $\phi = \phi(\varepsilon, \beta)$ with $\frac{\partial \phi}{\partial \beta} > 0$ and $\frac{\partial \phi}{\partial \varepsilon} > 0$. For the concave case, α_s is modeled as a multivariate function, $\alpha_s = \alpha(\varepsilon, \beta)$, with $\frac{\partial \alpha}{\partial \beta} > 0$ and $\frac{\partial \alpha}{\partial \varepsilon} > 0$.

To see how β and ε affect the valuation of the public good, take defense as an example. If the population believes that the probability of external conflict is minimal ($\beta \approx 0$), then the value of a

⁴ β and ε are constant across time and individuals. However, a fruitful avenue for further research is to model the evolution of beliefs and allow them to differ between individuals and to endogenize country technical capacity.

defense force is low. Also, if the technical capacity to build an effective and modern army is limited ($\varepsilon \approx 0$), again, the utility from consuming the public good will be low. Same goes for universal health care: if the population holds self-reliant beliefs ($\beta \approx 0$), large nation-wide transfer programs will not be valued highly. Furthermore, if the capacity to identify and develop high-quality health projects is missing ($\varepsilon \approx 0$), investing in universal health care is not an attractive option.

In period one, the incumbent can decide to augment the fiscal capacity – e.g., a tax authority, compliance structures – to achieve τ_2 by investing $\tau_2 - \tau_1$ at a convex cost $\chi(\tau_2 - \tau_1)$. The government's budget constraint at period s is given by:

$$R + \tau_s \omega = g_s + m_s + \frac{r_s^I + r_s^O}{2} \quad (2)$$

With $m_1 = \chi(\tau_2 - \tau_1)$, $m_2 = 0$, R natural resource rents and foreign aid, $\frac{r_s^I}{2}$ transfers to the incumbent group and $\frac{r_s^O}{2}$ transfers to the opposition group. Political institutions constrain the incumbent's allocation of transfers. Besley and Persson (2011) model this as a requirement to give a fixed share σ to the opposition group for any unit given to its own group. For convenience, they define $\theta = \frac{\sigma}{1+\sigma} \in [0, 1/2]$ to represent the 'cohesiveness' of institutions. A high θ can be interpreted as checks and balances on the executive and/or strong political representation of minority groups through proportional elections or parliamentary democracy.

The timing of the model is as follows:

1. The model begins with an initial stock of fiscal capacity τ_1 and an incumbent group I_1 . are determined. Nature determines α_1 , β , ε and θ .
2. I_1 determines policy $\{g_1, r_1^I, r_1^O\}$ and decides on τ_2 .
3. I_1 remains in power with probability $1 - \gamma$ and α_2 is determined.
4. I_2 chooses policy $\{g_2, r_2^I, r_2^O\}$.

The dynamic model is solved with backward induction, beginning at stage four. Given the linear structure of the model, the optimal policy can be determined for any level of fiscal capacity and irrespective of the identity of the incumbent. Whoever in power maximizes their own within-period payoff:

$$\max \alpha_s V(g_s) + (1 - \tau_1)\omega + r_s^I \quad (3)$$

subject to

$$R + \tau_s \omega \geq g_s + m_s + \frac{r_s^I + r_s^O}{2}, r_s^O \geq \sigma r_s^I$$

First the model is solved for the optimal amount of transfers. These values are plugged in equation (3), which is maximized to determine g_s . Concerning the transfers, the incumbent aims to make her group's transfer as large as possible. This results in the following solution:

$$r_s^J = \kappa^J [R + \tau_s \omega - g_s - m_s] \quad (4)$$

with $\kappa^I = 2(1 - \theta)$ and $\kappa^O = 2\theta$. The optimal provision of public goods is derived from the following equation:

$$\alpha V_g(\hat{g}(\alpha, x)) = x \quad (5)$$

with V_g the derivative of $V(\cdot)$ with respect to g and \hat{g} increasing in α and decreasing in x (due to concavity of $V(\cdot)$). The optimum is given by:

$$G(\alpha, \tau_s) = \begin{cases} R + \tau_s \omega - m_s \\ 0 \\ \hat{g}(\alpha, 2(1 - \theta)) \end{cases} \quad (6)$$

In the linear case where $V_g = 1$, two corner solutions appear. If public goods are considered extremely valuable, so that the marginal benefit from investing in public goods is greater than its opportunity cost, i.e., $\alpha V_g(R + \tau_s \omega - m_s) \geq 2(1 - \theta)$, then all tax revenue not spent on fiscal capacity is dedicated to public goods ($R + \tau_s \omega - m_s$). This is more likely to happen in countries with cohesive institutions, i.e., high θ , and/or when the value of public goods is high.

As modeled above, this depends (stochastically) on the beliefs policymakers hold vis-a-vis the public good and the country's technical capacity. *Ceteris paribus*, more positive views result in a higher expected demand and as such a higher provision of the public good. Also, countries that are able to identify high-quality public projects are more likely to engage in public spending.

The opposite corner solution, when $\alpha V_g(0) < 2(1 - \theta)$, all spending is devoted to transfers by setting $g_s = 0$. This is bound to happen when α is very low and/or when ϑ is close to zero. The latter reflects the finding that weak political institutions make private transfers attractive.

If we take $V(\cdot)$ to be a concave function, an interior solution is possible, i.e., the third line of equation (6), resulting in a mix of transfers and public goods spending. The optimum is found by setting the marginal value of public goods equal to the cost of forgone transfers. Again, spending on public goods depends on the cohesiveness of institutions, the beliefs policy-makers hold and country technical capacity.

To provide further insight, Besley and Persson (2011) show that inefficient policies are a real possibility in equilibrium. To do so, they first study a normative benchmark where a social planner maximizes the expected utility weighting the two groups equally. This corresponds to setting $\theta = 1/2$ and $\gamma = 0$. With a linear utility, the optimal policy is never to provide private transfers, i.e., $r_s^I = r_s^O = 0$, and spend all taxes on public goods. However, turning away from the Pigouvian case to a situation where $\alpha_L < 2(1 - \theta)$, the political optimum constitutes a policy failure as it includes transfer payments and an undersupply of the public good. The latter result corresponds to the findings of Acemoglu (2003), who shows that the lack of a credible commitment device – i.e., a low θ – induces a ruler to choose inefficient policies.

1.2 Implications and partial correlations

According to the model, the observed policy variation depicted in figure 1 crucially depends on the cohesiveness of institutions, θ , and the value of public goods, $\alpha = f(\varepsilon, \beta)$. For instance, when α is low – e.g., due to the views policymakers hold and/or limited technical capacity – and/or when θ is close to zero – due to weak political institutions – inefficient private transfers are likely to be chosen, resulting in an undersupply of public goods.

The available data seems to indicate that such conditions are not uncommon. Table 1 presents descriptive statistics for Polity IV's constraints on the executive (*xconst*), averaged by country over the period 1995-2010. This variable is used by Besley and Persson (2011) as a proxy for the cohesiveness of institutions. It is measured on a scale from 1 to 7 in each year, increasing in cohesiveness (1 corresponds to unlimited executive authority and 7 to equally shared responsibility). Though the mean value is reasonably high, 4.86, table 1 indicates considerable variation exists in executive constraints (st. dev. = 1.97). Furthermore, the data reveals that in no less than 47 countries executives face no or only limited restraints ($xconst \leq 3$), none of which are found in Latin-America and the Caribbean. Taking a regional view, LAC has the second highest score on average (5.84), behind the Western countries (6.95). Caribbean countries score slightly higher than the Latin American ones on executive constraints (6 vs. 5.81).

Table 1 also shows descriptive data – based on the World Values Survey – for the views people hold concerning the role of self-reliance in determining income and success (again, averaged by country for the period 1995-2010). Scores range from 1 to 10, from “hard work usually brings a better life” (1) to “hard work generally doesn't bring success; it's more a matter of luck and connections” (10). Overall, people are inclined to believe that hard work brings success. But here too cross-country variation exists in beliefs people hold: the minimum score is 2.36 (Bangladesh) while the maximum value is close to 5.88 (Poland). Taking a regional perspective, individuals in Latin-America and the Caribbean (4.47) are less inclined to believe that hard work brings success, as only two other regions – Eastern Europe and Central Asia (4.64) and the West (4.72) – score higher.

Finally, as a crude proxy for the capacity to generate evidence about policy effectiveness,⁵ Table 1 shows descriptive data for the average number of scientific journal articles countries produced over the period 1995-2010. The data indicates that 53 countries did not succeed in producing at least 10 articles on average, suggestive of limited evidence for policy analysis. Of the 53 countries, 15 – which is close to 30 percent – are found in Latin-America and the Caribbean; half of the Caribbean countries – Bahamas (2), Guyana (5), Suriname (3) – belong to that group. Therefore, is it no surprise that LAC does not score well on this variable, only surpassing Africa and the Middle East behind in terms of scientific publications.

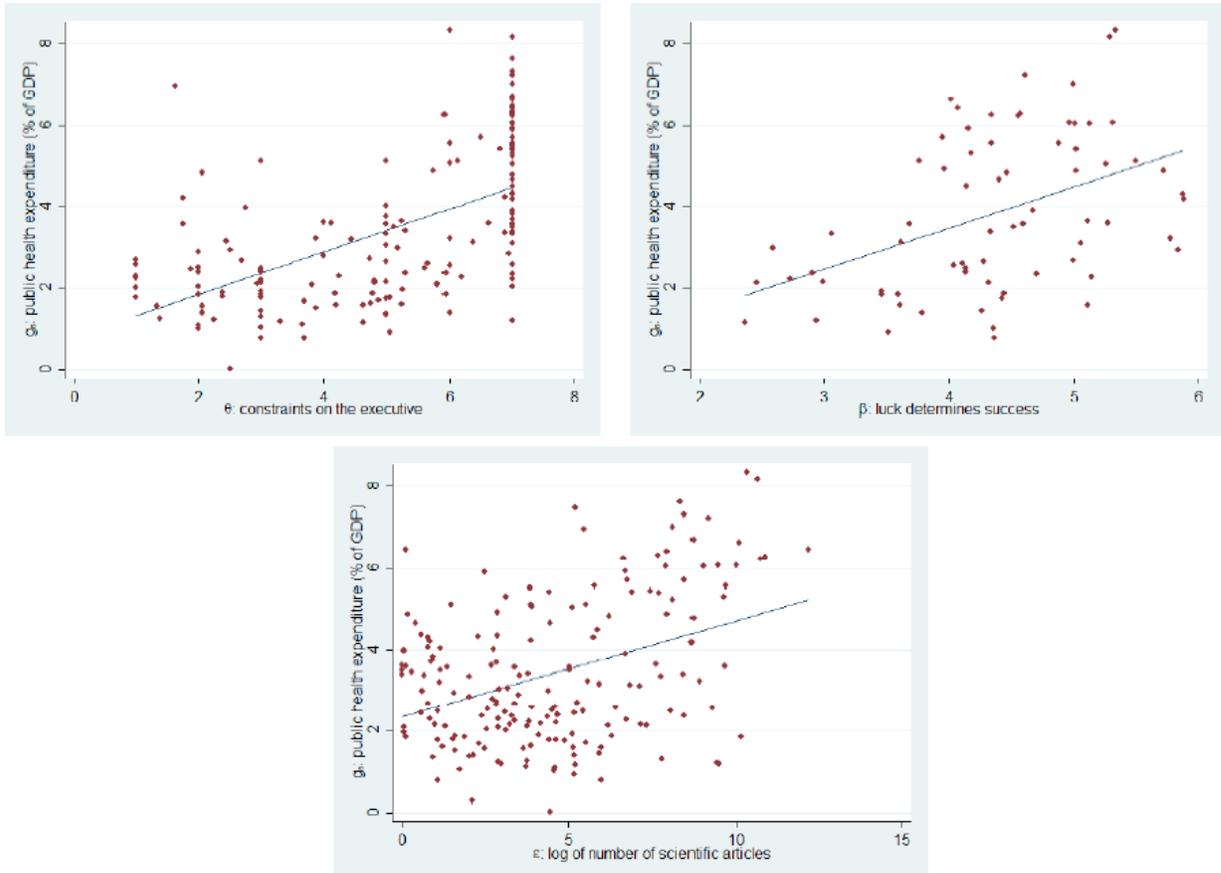
Table 1: Summary Statistics of the Key Parameters

Variable	Mean	Std. Dev.	Min.	Max.	Obs.
Executive constraints (θ)	4.866	1.974	1	7	160
Luck determines income (β)	4.372	0.844	2.367	5.878	71
Scientific articles (ε)	3,575	16,112	0	198,219	189

⁵ The number of publications is an imperfect proxy for technical capacity, e.g., it measures output rather than human capital.

For illustrative purposes, figure 2 shows the linear association of the key parameters with public health spending (as a % of GDP). As predicted by the theory, all three variables exhibit a strong positive correlation with health expenditures (0.557, 0.443 and 0.228 for executive constraints, self-reliant beliefs and log of scientific articles respectively).

Figure 2: Linear Association of Key Parameters with Public Health Spending (g_s)



Additionally, table 2 shows the results from including income and population as additional covariates in a very simple cross-country regression. Table 2 indicates that partial correlations for all three key variables are significantly positive, for beliefs even beyond the one percent level.

Table 2: Partial Correlations of Key Parameters with Public Health Spending (g_s)

Variable	Coefficient	Standard Error
Luck determines success	0.522***	(0.153)
Executive constraints	0.202*	(0.119)
Scientific articles	0.00005**	(.00002)
Per capita GDP	0.0001***	(.00001)
Log of population	-0.323**	(0.137)
Intercept	4.980*	(2.923)
N	69	
R ²	0.66	

Note: Significance levels: *: 10%, **: 5%, ***: 1%. Robust standard errors in parentheses.

3. Limits and Opportunities for External Policy Support

The model above explains policy failure as result of weak institutions and/or a low demand for public goods. Given such conditions, which prevail widely, external policy support may be of some benefit. Indeed, many organizations outside a country's formal decision-making bodies are engaged in providing assistance for policy reform. For instance, leading international financial institutions (IFIs) such as the Inter-American Development Bank (IDB) and the World Bank play a key role in this. Take the IDB. After the LAC debt crisis, the Bank realized the need for an instrument to support policy reform. Therefore, the IDB introduced policy-based lending (PBL), a lending modality that provided conditional budget financing. PBLs were to be disbursed in several tranches, conditioned on the compliance with a set of agreed-upon policy actions. Since the start in 1989, the Bank has approved about 300 PBLs, worth more than \$45 billion. This corresponds to roughly 25% of total Sovereign-guaranteed (SG) lending and 28% of SG disbursements (OVE, 2016).

So then, how can external agents – like the IDB – effectively support reform processes? The theoretical framework suggests a number of margins for external agents to focus on if they wish to improve the policies recipient countries select and implement. First, much in line with IDB's policy-based lending, a foreign aid agency could transfer resources to a recipient country's budget, ΔR , conditional on policy reform. Second, external agents could buy a seat at the government table to discuss new policy options and aim to persuade government officials to update inaccurate beliefs ($\Delta\beta$). A third strategy entails supporting change in political institutions, $\Delta\theta$, making them more cohesive through introducing elections or a multi-party system. A fourth way for external agents to influence policy choice is the provision of technical assistance to identify effective public interventions.

Formally, the timing of the model is modified as follows:

1. As before, the model begins with an initial stock of fiscal capacity τ_1 and an incumbent group I_1 . β_0 , ε_0 and θ_0 are determined.
2. The external actor steps in:
 - 2.1 and offers ΔR conditional on policy reform;
 - 2.2 or buys a seat at the policy table to influence beliefs: $\Delta\beta = \beta_1 - \beta_0$;
 - 2.3 or aims to improve the cohesiveness of institutions: $\Delta\theta = \theta_1 - \theta_0$;
 - 2.4 or providing evidence concerning the effectiveness of different policy proposals.
3. Nature determines α_1 .
4. I_1 determines policy $\{g_1, r_1^1, r_1^0\}$ and decides on τ_2
5. I_1 remains in power with probability $1 - \gamma$ and α_2 is determined.
6. I_2 chooses policy $\{g_2, r_2^1, r_2^0\}$.

In the remainder of this study I will briefly discuss the limits and opportunities of each of these efforts.⁶ To support policy change, donor agencies typically transfer financial resources to the recipient country's budget, conditional on meeting certain reform actions. In case of congruent preferences all the extra resources, ΔR , will be spent on public goods. In such a case there is no need for conditionality. However, weak political institutions ($\theta \approx 0$), and/or low valuations of the public good ($\alpha \approx 0$), give rise to conflicting objectives: without conditionality the recipient country spends the additional funds on private transfers rather than on public goods. In the latter case an aid contract between donor and recipient may help in bringing about change. However, a large theoretical and empirical literature has shown that, without the commitment on the recipient side, aid contracts are unlikely to induce policy reform (see, e.g., Svensson, 2003). In such a case, aid relationships are characterized by a Samaritan's Dilemma where external agencies transfer resources and recipients refrain from reforming (Buchanan, 1975).

Commitment for policy reform can be built though by increasing the demand for public policies through policy dialogue ($\Delta\beta$) and by providing evidence concerning the effectiveness of different policy proposals. Concerning the former, there are substantial reasons to assume considerable variation exists in the beliefs people hold. To the extent that we have reasonable knowledge that certain beliefs are inaccurate – e.g., “nationalizing all private enterprises is good for the economy” – it might be worthwhile for external agents to engage in policy dialogue and persuade government officials to change their attitude ($\Delta\beta > 0$). For example, Smets et al (2013) describe a case where a World Bank staff team, after long negotiations, was able to convince the Marxism-Leninism inspired government of Mozambique to (successfully) privatize the telecommunications market. The authors mention that a presentation showing the positive impact of telecom privatization – with examples all over the globe – was instrumental in shifting the mindset, leading to increased ownership over the reform program.

When countries lack the technical expertise to identify and design high-value public programs, external agents may step in and provide assistance to find out what works. However, this is not straightforward. The fundamental problem when comparing feasible public interventions is the absence of the counterfactual. Luckily, rigorous methods – e.g., RCTs – have been developed over the past decades to assess policy effectiveness. However, it is important to note that statistical methods are based on assumptions to draw inferential conclusions.⁷ Consequently, when providing assistance in public policy analysis, external agents should make sure that their advice is based on credible assumptions.

Not doing so can have disastrous implications. For instance, the 2010 adjustment program the so-called Troika – the European Union, The European Central Bank and the IMF – set up in

⁶ See Smets (2018) for a more detailed analysis of the abovementioned factors to influence policy reform.

⁷ For instance, for IV techniques to be valid, the instruments employed need to be exogenous, i.e., orthogonal to the error term. This assumption requires more than instruments not being determined by the variables in the model, it requires (statistical) independence. Regression discontinuity assumes that around the threshold treated individuals have similar distributions of treatment response. Differences-in-differences methods allow outcomes to differ across treated individuals but assume that the observations in a study are subject to a similar time trend and respond identically to treatment. Theoretical modeling techniques also need assumptions and decisions rules to generate predictions. Even though in theory RCTs require minimal assumptions, in practice they also deserve scrutiny. First, generally it is assumed that treatment response is individualistic. However, when members of a population potentially interact with each other -- like in a vaccination program -- the predictive power of RCTs is compromised. And second, in order for RCTs to have external validity, it is required that the experimental distribution of outcomes is the same as the population distribution of outcomes, which is far from guaranteed. For instance, the study population might be different from the population of interest due to non-random partial compliance. Also, the experimental treatments might differ from the ones offered in actual policies.

Greece was based on unrealistic growth assumptions. When the program broke down due to a far worse growth performance than projected, the IMF realized that

[W]ith the benefit of hindsight, the macroeconomic assumptions at the initiation of the program proved optimistic. In this regard, an earlier debt restructuring exercise – if it had been feasible – could have provided for a somewhat more gradual fiscal adjustment path' (IMF, 2013, p.6).

As a solution, Manski (2011) proposes to use layered policy analysis that starts with weak, but credible assumptions and then moves to findings based on stronger, less credible ones. Deaton (2010) adds that, for empirical research to be useful for policy analysis, it needs to be embedded in theory that explains the underlying mechanisms.

Next to the beliefs policymakers hold and evidence about policy effectiveness also the cohesiveness of political institutions determines policy choice. Given the importance of inclusive political institutions, many external agents make resources available to change the structure of the political system in recipient countries. For instance, Africa's third wave of democratization in the early 1990ies was heavily supported by Western countries (Van de Walle, 2001). Several strategies – electoral support, building of a party system, etc. – are employed to constrain policymakers and build commitment devices for enhanced policymaking. However, it is important to realize that political institutions are not subject to linear change but are determined in a dynamic way (see Aghion et al, 2004; Robinson and Torvik, 2016). Supporting political change without taking into account general equilibrium effects may actually be counterproductive (i.e., the danger exists that $\Delta\theta < 0$).

For example, elections can be regarded as a mechanism to make governments accountable, retaining good performers in office and removing those who do not (see, e.g., Przeworski et al, 1999). However, in contexts without complementary institutions that constrain the behavior of politicians, supporting the introduction of democratic elections may not be of much avail (IOB, 2012). Indeed, Chauvet and Collier (2009) find empirical evidence that frequent elections improve economic policymaking, however not so in developing countries with low-quality electoral systems.

4. Summary and Concluding Remarks

In reality, policies are not designed and implemented by a welfare-maximizing planner but are determined through a political process. As such, there is no guarantee that efficient policies will be selected in equilibrium. A slightly modified version of Besley and Persson (2011)'s core model explains policy failure as the result of weak political institutions, negative views vis-a-vis public goods and/or limited technical capacity for identifying and designing high-quality public programs. In this respect, the paper resembles that of Banerjee and Duflo (2014), who argue that (deterministic) political institutions are not the only factors that influence policy reform, but that leaders, their decisions, and their expectations play a role as well.

In light of these results, the limits and opportunities are briefly discussed for external agents to support policy reform. It is argued that without commitment on the side of the recipient, conditional financing is unlikely to induce policy reform. One way to create commitment for reform is through belief change. That is, beliefs matter for policy choice, they tend to vary and are potentially open

to change. Therefore, when acquiring a seat at the policy dialogue table, it is important for external agents to detect the beliefs policymakers hold and be able to persuade government officials to change inaccurate attitudes. Furthermore, sound evidence about the costs and benefits of policy proposals may increase the valuation public goods, which may induce policymakers to select high-quality public policies. When countries lack the technical expertise to identify and design high-value public programs – which seems to be a binding constraint in LAC, external agents may step in and provide assistance to find out what works. However, as a cautionary note, this paper highlights that external agents should not overshoot the mark and provide policy advice based on credible assumptions.

Finally, this study provides several avenues for further research. Theoretically, it would be interesting to endogenize the evolution of beliefs and allow them to differ between individuals/groups. Also considering investments in technical capacity as a choice variable could reveal some valuable insights. Furthermore, in the same spirit as Clist et al (2012), there is a need to think more coherently about the instruments available to external agents. For instance, is there an optimal sequencing of instruments?⁸ Next, enriching the analysis by developing donor-recipient interactions more fully could help to answer several questions. For example, which donors are offered a seat at the policy table? Under what conditions are external agencies allowed to test policy alternatives and how does learning affect the political equilibrium?⁹ Empirically, an attempt could be made to perform a causal test of the theory and estimate the relative importance of each of the key parameters. Furthermore, in the same vein as Esterling et al (2013), there is a need to produce more empirical evidence on belief formation, belief change and persuasion in the context of policy reform.

⁸ This analysis suggests is optimal for donors to first aim for belief change and/or capacity building (as to arrive at congruent preferences), and afterwards transfer resources to a recipient country's budget.

⁹ Manski (2013) notes that learning will be beneficial in a society when policy disagreements arise due to belief differences. If, however, heterogeneity of policy preferences arises from conflicting objectives, learning might increase polarization and induce conflict.

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