Supporting Policy Reform from the Outside

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Sound economic and social policies are important if countries wish to prosper and achieve sustainable development. It is far from guaranteed, however, that policymakers select and implement good policies, which provides a rationale for external policy support. Indeed, many organizations are engaged in supporting policy reform processes in recipient countries. This study investigates the limits and opportunities of supporting policy reform by focusing on four dimensions of support: conditional financing, policy dialogue, technical evidence and political institutions. Four findings follow from a review of the literature. First, without commitment on the recipient side, conditional financing is unlikely to induce policy reform. Second, when external actors acquire a seat at the policy dialogue table, it is important to detect (and influence) the beliefs policymakers hold. Third, outside parties should bring sound evidence to the table about the costs, benefits, and effectiveness of their policy proposals. Finally, supporting changes in political institutions without considering general equilibrium effects can be counterproductive. The study concludes with a discussion and some avenues for future research in this field.

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Introduction

Public policies are needed to provide public goods and address externalities, should aim for equitable redistribution, and support a good functioning of the economy. Sound economic and social policies are therefore important if countries wish to prosper and achieve sustainable development. 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

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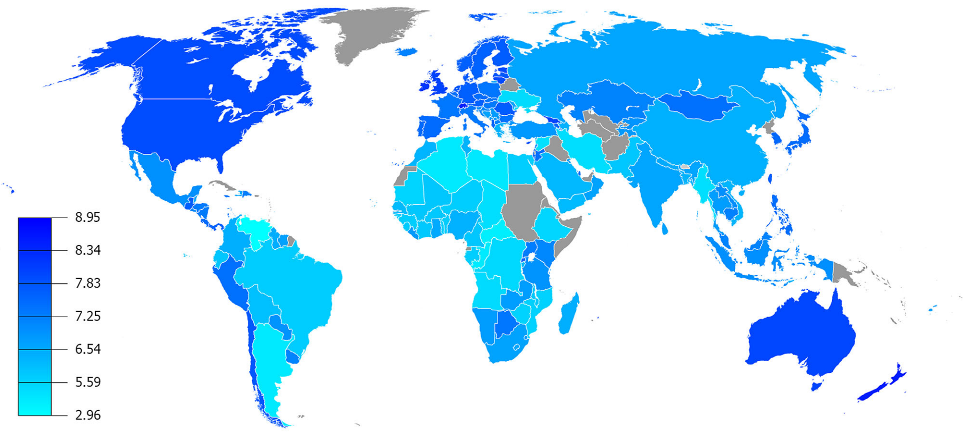
Figure 1. Quality of the Policy and Institutional Framework, 2015



Fraser Institute's 2015 Economic Freedom of the World Index. Darker shades of blue indicate higher policy quality. No data for gray-shaded areas.

Source: Gwartney, Lawson, and Hall (2015).

are associated with investment and economic growth. With regard 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. Henry and Miller (2009) compare the growth experience of Barbados and Jamaica and conclude that—next to the broader institutional framework—macroeconomic policies also matter for economic success.

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. The figure 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.[1] Scores range from 1 to 10. Figure 1 shows that considerable variation exists in the quality of policies that 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. Though most countries with below-mean policy ratings are found in Africa, other regions also include countries with low quality policies. For example, Myanmar, Ukraine, and Argentina all scored more than one standard deviation below the mean.

Given that countries could end up with bad policies, external policy support may be of some benefit. Indeed, many organizations are engaged in supporting policy reform processes in recipient countries. International financial institutions (IFIs) such as the World Bank and the IMF play a leading role in this.[2] For example, since 1980 the World Bank has provided conditional financing to recipient governments to support specific policy and institutional reforms. The World Bank's development policy loans (DPLs) seek to improve policy in many different sectors, from economic management to public-sector governance.

Supporting policy reform has become an important component in the financing of development operations. For example, from 2009 to 2012, World Bank development policy lending reached around $45 billion. Furthermore, Clemens and Kremer (2016) and Ravallion (2016) see the provision of well-informed policy advice as one of the key roles of development institutions such as the World Bank. Clemens and Kremer (2016) note that:

> "In many of the countries where the [World] Bank operates, political competition is focused on patronage or ethnic and cultural issues rather than economic policy. Think tanks are scarce, and the senior civil service is stretched thin. In this environment, Bank staff can have tremendous influence [...] Bank staff have access to policymakers and often build relationships of trust with key civil servants. Politicians will make the overall decision about whether, say, a conditional cash transfer policy should be implemented. But the World Bank can then have huge influence on decisions regarding the details and implementation of the program."

The available evidence thus far suggests that success in supporting policy change has been uneven.[3] For instance, analyzing the change from 1982 to 1995, Knack (2001) finds that higher levels of official development assistance (ODA) negatively affect corruption in government, bureaucratic quality, and adherence to the rule of law. Brautigam and Knack (2004) repeat this exercise for Sub-Saharan Africa and come to similar conclusions. Smets and Knack (2018) focus specifically on the World Bank's DPLs that target public sector governance. The authors present empirical evidence—using data from a panel of aid-receiving countries from 1996 to 2008—that development policy loans are not effective in supporting anticorruption or civil service reform. The authors do show that the DPLs are able to improve the quality of budgetary and financial management, which accords to similar findings from other studies (World Bank 2008; de Renzio 2009).

A related pattern appears when looking at policies for social inclusion (i.e., gender equality, social protection, environmental sustainability). Bogetic and Smets (2017) investigate the association of World Bank policy lending with social development policies over the period 2006–2014. These authors find econometric evidence that DPLs targeting social protection and environmental sustainability are effective at influencing policy, but that policy loans related to gender equality and health and education reform have no significant impact on policies in those areas.

Finally, the empirical literature indicates that foreign assistance has been instrumental in improving the quality of economic management (i.e., macroeconomic stabilization, debt management, trade and business regulation). Covering the years 1970–1997, Boockmann and Dreher (2003) show that World Bank lending is able to improve the quality of economic policies, a finding recently corroborated by

Smets and Knack (2016). Analyzing the period 1995–2008, Smets and Knack (2016) present econometric evidence that the quality of economic management increases with the cumulative number of World Bank economic policy DPLs. Moll and Smets (2018) repeat this exercise for the period 1998–2015 and come to similar conclusions. Kilby (2005) shows that multilateral aid was effective in supporting factor and output market deregulation during the period 1970–2000. Banerjee and Rondinelli (2003) present empirical evidence spanning the period 1988–1999 that shows foreign aid does not affect the timing of privatization, but that technical assistance has a positive effect on the implementation of privatizations. Finally, Giordano and Pagano (2017) econometrically show that World Bank DPLs were able to facilitate the ease of doing business during the period 2004–2014, especially for less developed countries.

What then can we learn from these results to better support policy reform processes? Building on the existing literature, I will argue that policy dialogue and high-quality evidence are important, more so than the financial arrangements or conditions that often come with it. More specifically, I will make four points. First, without commitment on the recipient side, conditional aid contracts are unlikely to induce policy reform. Second, when external actors acquire a seat at the policy dialogue table, it is important to detect the beliefs that policymakers hold and be able to persuade government officials to change inaccurate attitudes. Third, outside parties should bring sound evidence to the table—not best-practice—about the costs, benefits, and effectiveness of their policy proposals. High-quality, technical evidence may increase the demand for public policies and serves a crucial input for the design of policy reform operations. Finally, an alternative (and indirect) route for external actors to encourage policy reform is to support changes in political institutions. I will argue, however, that doing so without considering general equilibrium effects can be counterproductive.

The next section elaborates on the four abovementioned ways to influence policy reform, that is, conditional financing, policy dialogue and belief change, technical evidence, and supporting changes in political institutions.[4] The final section offers some concluding remarks and avenues for future research.

Supporting Policy Reform from the Outside

Building on a large review of the literature, this section discusses the limits and opportunities to influence policy reform along four dimensions. The first sub-section examines conditional financing and indicates that without commitment, aid contracting is unlikely to induce sustainable change. The second sub-section argues that policy dialogue may build commitment for reform through belief change, while the third sub-section provides several arguments for why sound evidence is conducive to policy reform. Finally, sub-section four points to the risks of supporting changes in political institutions.

Contracting for Policy Change

To support policy change, donor agencies typically transfer financial resources to the recipient country's budget, conditional on meeting certain reform actions. Building on principal-agent theory, I illustrate in this section the limits and opportunities of using aid contracts to support policy reform.

Azam and Laffont (2003) provide a benchmark study in this respect. The authors investigate how an aid contract between donor and recipient can affect a developing country's redistribution policy. Assuming that the donor can credibly commit, the authors find that financial transfers induce a more equitable redistribution, even in the case of asymmetric information. In a variation, Cordella and Dell'Ariccia (2002) assume that some of the relevant policy actions under recipient control are not observable. The authors show that the use of conditionality, targeted at observable (and thus contractible) components, increases social spending, albeit inefficiently. These stylized models thus indicate that conditional financing, to a greater or lesser extent, is able to induce policy reform.

There are, however, some inherent difficulties in using aid contracts for policy change. Historically, contract theory originated when studying labor relations between employer and employee. Applying these methods to sovereign nations fundamentally limits the use of contractible variables. In other words, when contracting for policy reform, an independent arbitrator—that is, an international court of law—is lacking ability to punish any player who breaks contract stipulations. So, in case a recipient government cannot commit to contract conditions, the financial incentives provided in the contract will no longer guarantee effective policy reform.

As Azam and Laffont (2003) note, a possible way to get around post-contractual opportunism is for the donor to commit aid *ex ante* and design a credible contract such that aid is disbursed only after observing reform. However, Svensson (2003) and Kilby (2005) provide empirical evidence that donors often fail to enforce contract conditions due to spending pressure, defensive lending or political pressure from powerful donors. Consequently, without commitment the moral hazard problem persists, and the relationship is characterized by a Samaritan's Dilemma where donors transfer resources and recipients refrain from reforming (Buchanan 1975; Svensson 2000).

These theoretical results are corroborated by many qualitative and quantitative studies which show that, without engagement on the side of the recipient, the implementation of conditional financing is bound to fail (see, e.g., Killick 1997; World Bank 1998; Devarajan, Dollar, and Holmgren 2001; World Bank 2001; Dijkstra 2002; Svensson 2003; World Bank 2005; Dreher 2009). For instance, using principal-agent theory to analyze a sample of 21 developing countries, Killick (1997) finds that political consensus in the recipient country concerning the proposed reforms has a decisive influence on effectiveness of IFI conditionality. Devarajan, Dollar, and Holmgren (2001) present 10 insightful country cases regarding the World Bank's early experience with policy reform in Africa. The 1987 structural adjustment credit in the Democratic Republic of Congo (DRC) provides a telling illustration. In June 1987, the World Bank approved a Structural Adjustment Credit, including measures to reform the public investment program. However, even before the loan was declared effective, large inefficient investments were initiated outside the agreed-upon investment plan. As a result, the World Bank reform program had to be abandoned. Devarajan, Dollar, and Holmgren (2001) relate the failure to the DRC leadership and note that President Mobutu had no intention of making any change in the way he was handling the country.

Though Azam and Laffont (2003) provide a useful and tractable benchmark, in reality the principal-agent relations of policymaking are more complex. Dixit (2003) notes that

> "There are multiple horizontal links; each principal has several agents, and most importantly in many political contexts, each agent is simultaneously answerable to several principals whose interests are not perfectly aligned and who act non-cooperatively in trying to influence the agent's actions [...] In such a relationship, we have the usual problems of moral hazard and asymmetric information. They are made more complex by the multi-task and multi-principal features, and by the possibility of collusion among a subset of agents."

The 1987 DRC reform program again offers a neat example. Devarajan, Dollar, and Holmgren (2001) state that the dialogue between the World Bank and high-level government officials was open and productive, with a broad consensus on the reform agenda at that level. President Mobutu, on the other hand, completely disregarded the loan conditions and continued with discretionary spending, leading to the breakdown of the reform program.

To incorporate the issue of multiple principals and multiple agents, several common agency models have been developed. For instance, Martens et al. (2002) extend the basic principal-agent analysis and study agency models with multi-tasking, multiple players, and incomplete contracting. In that volume, Murrell (2002) shows that multiple equilibria are possible when an external agent hires a local contractor to design a legal reform that might affect recipient country interest groups. Similarly, Mourmouras and Mayer (2009) find that a powerful interest group might block an economic reform program proposed by an IFI.

An added problem of using conditional financing relates to incentive compatibility and participation, that is, recipients must be motivated to fulfill contract conditions. While there are some reported cases where the availability of funds played a positive role (Devarajan, Dollar, and Holmgren 2001; Dijkstra 2002), most of the available empirical evidence fails to find any significant effect of loan size on reform success

(Dollar and Svensson 2000; Malesa and Silarszky 2005; Moll, Geli, and Saavedra 2015). Given the limited impact of financial transfers, it is worthwhile considering other incentives that might incite a government to engage in policy reform.

Incentive compatibility may also explain the limited success in supporting public sector governance reform. Implementing reforms is (politically) costly in the short term, especially in the public sector, which is often used as an instrument for patronage and clientelism (Devarajan, Khemani, and Walton 2011). On the other hand, the benefits from building a well-functioning state apparatus may take several years, if not decades (Pritchett and de Weijer 2010). For many governments, this time inconsistency problem makes it unattractive to engage in public sector reform.

Next to providing the right incentives, the timing of external support also matters. An important issue often stressed in the literature is that the occurrence of an economic crisis provides a window of opportunity for change (see, e.g., Ranis and Mahmood 1992; Krueger 1993; Haggard and Webb 1994; Alesina, Ardagna, and Trebbi 2006). That is, a deep economic crisis dramatically reduces the reservation utility for engaging in reform. Indeed, Smets, Knack, and Molenaers (2013) find empirical evidence that deteriorating economic conditions motivates governments to reform.

Dialogue for Belief Change

The previous section shows that commitment—or so-called ownership—is needed on the side of the recipient for policy reform support to be successful. In this section I argue that policy dialogue may build ownership for reform through belief change.[5] I first show that beliefs matter for policy choice. Then I assert that new information may lead policymakers to update their beliefs—but not necessarily so—and that also non-informative dimensions of communication matter for believe formation. I conclude the section by highlighting cases where external agents were instrumental in influencing policymakers' mindset, resulting in increased commitment for reform.

A burgeoning literature convincingly shows that the views policymakers hold concerning the functioning of the economy and the way they learn from past experiences determines policy choice. For instance, in a recent paper Rodrik (2014) neatly illustrates the importance of beliefs for policymaking:

> "Policymakers operate under certain working assumptions about how the world works. Their worldviews shape their perception of the consequences of their and others' actions in both economic and political domains. These ideas may fall on either side of some of the biggest controversies in the history of economic thought: Does the economy work better under laissez-faire or planning? Are economic growth and development more rapid under free trade or under protection? [...] Each of these positions presumes a particular model of how the economy works and therefore has different implications for political behavior."

Mukand and Rodrik (2018) formalize these ideas and show how worldviews—that is, the electorate's understanding of how the world works—can be incorporated in standard political economy models of policymaking. In another study, Buera, Monge-Naranjo, and Primiceri (2011) develop a Bayesian learning model in which policymakers decide whether or not to pursue market policies based on updated beliefs concerning the growth performance of market and interventionist economies. These authors find empirical evidence 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 econometrically show that the evolution of beliefs—and not redistributive concerns—crucially explains the observed dynamics of policy adoption. Bénabou and Tirole (2006) provide another illustration. These authors 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. Based on a model of imperfect will-power, Bénabou and Tirole (2006) show that 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, Montalvo, and Reynal-Querol (2011) provide empirical evidence that more educated leaders are associated with higher growth rates, hence linking cognitive characteristics of political leaders with economic and policy outcomes.

The above shows that beliefs matter for policy choice. While it is beyond the scope of this article to provide a comprehensive overview on the evolution of beliefs, I first present some research to show that beliefs can be influenced by information exchange. Murphy and Shleifer (2004) present a model where beliefs are transformed due to communication in a network, where interactions may take the form of information exchange. Glazer and Rubinstein (2004) show the conditions under which a speaker is able to persuade an imperfectly informed decision maker to take a certain (policy) action, only using verbal information. Similarly, Kamenica and Gentzkow (2011) investigate the issue of persuading, that is, changing the beliefs of a rational agent by sharing information, and conclude there is substantial scope to do so. The authors apply their theoretical insights to a setting where an economic agent commissions a study to influence a politician. Kamenica and Gentzkow (2011) show that the study will help in persuading the politician if the preferences of the agent and the politician are sufficiently aligned. Finally, Della Vigna and Gentzkow (2009) review the empirical literature on persuasion and conclude that persuasive communication is at least somewhat effective in influencing behavior, especially if it involves personal contact. In some settings, receivers of information respond more when they are more uncertain and when the information conveyed is credible.

Accurately updating beliefs based on new information is the traditional way that economists analyze belief formation. However, it is important to note that information exchange does not always help in changing beliefs. For example, cognitive limitations and behavioral biases may prevent Bayesian updating from taking place. Furthermore, Bénabou and Tirole (2016) forcefully argue that beliefs also fulfill important functional and psychological needs of the individual, such as moral esteem or self-confidence, which may make them resilient to many forms of information. The mechanisms that prevent beliefs from being updated (in a Bayesian sense) include strategic ignorance, reality denial, and self-signaling.[6]

For instance, many at-risk subjects refuse to be tested for terminal diseases as the results may drastically alter their beliefs and expectations (Oster, Shoulson, and Dorsey 2013). Examining the beliefs of developing country government officials, Vivalt and Coville (2019) experimentally show that government officials are biased towards good news and overweigh the positive results from impact evaluations. Interestingly, the authors also find evidence that providing more detailed information leads government staff to more precisely update their beliefs. Banuri, Dercon, and Gauri (2017) investigate how World Bank staff interpret information about the impact of a (fictitious) development intervention that raised minimum wages. These authors find experimental evidence that World Bank staff's assessments are biased towards their prior beliefs regarding redistribution, which is suggestive of confirmation bias.[7] Finally, experimental evidence from psychology shows that subjects are more likely to believe assertions when they are repeated, irrespective of whether the statements were true or false (Hasher, Goldstein, and Toppino 1977).

Besides information, other, non-informative dimensions of communication also influence the evolution of beliefs. For instance, Mullainathan, Schwartzstein, and Shleifer (2008) model a persuasion game where individuals are coarse thinkers, that is, they think in categories and apply the same causal model to all situations in a category. This allows persuaders to exploit the fact that situations can be framed in several ways, and that individuals transfer certain properties to other situations.[8] Bassi and Razul (2017) present empirical evidence on how non-informative but highly salient communication by a leader affects beliefs. These authors do so in the context of the 1991 Papal visit to Brazil, and show how persuasive but non-informative messages by John Paul II increased fertility-related beliefs. This finding corresponds to research in social psychology about the persuasive power of authority figures (see, e.g., Cialdini 2007). Finally, Custer et al. (2015) report that government officials appreciate policy advice more when they had a work history with the development institution that provided the information.[9] This result is consistent with the idea that shared identity matters for belief formation (Gennaioli and Tabellini 2018).

Given that beliefs determine policy choice, and given that they are potentially flexible, it is important for external agents to detect the beliefs that policymakers hold and be able to influence beliefs during policy discussions. Haggard and Webb (1994) note that in the long run, the transmission of ideas may be more important for policy reform than conditional financing. The authors present several cases demonstrating the powerful effect of policy dialogue on the reform process.

The Polish recovery program in the early 1990s provides a case in point. At the beginning of 1990, the Polish government implemented a radical reform program that brought inflation down, reduced external imbalances, and made the currency convertible. Before coming to power in 1989, the ruling party did not have any clear ideas about which economic policies to implement. Johnson and Kowalska (1994) argue that Jeffrey Sachs and David Lipton played an influential role in shaping the reform program. After months of intense discussions with senior political leaders, many of their ideas were actively taken on board by the key political actors in Poland.

Smets, Knack, and Molenaers (2013) provide another example. In the early 2000s, Mozambique successfully privatized their telecommunications sector, supported by a World Bank policy loan. Faced with the Marxism-Leninism inspired Frelimo, it took the World Bank considerable effort to convince the Ministry of Planning to allow a second player into the telecommunications market. A number of political advisors to the Minister of Planning openly questioned the benefits of privatization and claimed that only a state monopoly would serve the people. An extensive World Bank staff team, however, succeeded in convincing the Mozambican government officials. The task team leader at the time recalled that a presentation showing the positive impact of telecom privatization—with examples from all over the globe—was instrumental in shifting the mindset. After the negotiations, the government of Mozambique expressed a clear and firm commitment to implement the program. Smets, Knack, and Molenaers (2013) argue that the extensive negotiation process facilitated belief change concerning the benefits of market reform, which increased ownership over the reform program.

Evidence for Change

The previous section has shown that evidence and new information may—but not necessarily will—help in changing a policymaker's attitude. Sound evidence about the costs and benefits of policy reform can also be used to reduce (pervasive) uncertainty regarding the winners and losers of reform. That is, at the core of many political economy models are politicians who are interested in redistributing power and income to a certain subset of the population. Not knowing how the benefits and costs of reform will be distributed may prevent reform from taking place (Fernandez and Rodrik 1991; Majumdar and Mukand 2004). Fernandez and Rodrik (1991) refer to the early 1960s where the South Korean business community fiercely opposed trade liberalization since it was difficult to determine *ex ante* which sectors would win. Therefore, providing evidence about the distributional impacts of policy change may unlock the status-quo.

This requires a thorough political economy analysis (PEA) about how different interest groups are related to the political elite and how they would be affected by reform. Over the past two decades many PEA tools have been developed to assist external agents in understanding the power relations in recipient countries. For instance, the Swedish International Development Cooperation Agency (SIDA) developed a method called Power Analysis to identify such issues. A recent evaluation on the use of PEA in development policy lending indicates that DPLs that include a PEA are more effective in reaching their reform objectives (Independent Evaluation Group 2016).

Relatedly, evidence can also be used to increase the demand for public policies. That is, due to various barriers and limitations, countries may lack the capacity to generate and process the information necessary to identify high-value public policies. 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). Spolaore and Wacziarg (2009) take a different approach and show that biologically and culturally transmitted traits and characteristics may prevent countries from adopting knowledge and new technologies. When countries are disadvantaged in such ways, public programs are not expected to generate high returns. Consequently, policymakers will not be inclined to allocate resources to public spending (Besley and Persson 2011a).

When countries lack such technical expertise, external agents may provide assistance to find out what works and thus increase the valuation and selection of sound public policies (Besley and Persson 2011a). For instance, over the past decades, rigorous methods have been employed to assess program effectiveness.[10] The Abdul Latif Jameel Poverty Action Lab (J-PAL) is a global network of researchers who use randomized controlled trials (RCTs) to provide scientific evidence for enhanced policy effectiveness (Duflo, Glennerster, and Kremer 2008). Since its inception in 2003, J-PAL has performed more than 900 randomized evaluations in 80 countries, covering themes that range from microfinance and health to political economy and governance. Where RCTs are not feasible or possible (how to randomize monetary policy?) more and more econometric studies employ advanced quasi-experimental designs such as instrumental variables, regression discontinuity, or differences-in-differences (Angrist and Pischke 2010).

That being said, it is important to note that it is not always straightforward to generate high-quality evidence about policy effectiveness. Our knowledge is limited with respect to the equilibrium outcome we can expect from policy reform. Even if we assume a competitive economy with complete information, one cannot exclude the existence of multiple equilibria given the implementation of a set of policy instruments (Arrow and Hahn 1971). In more realistic settings, many policy decisions are made in the face of ambiguity, or what Knight (1921) called fundamental uncertainty. In such a case, we do not know the distribution of how policy actions map into policy outcomes, hence precluding the choice of optimal policy (Manski 2000).

More and more, it is argued that policy design should embrace economic complexity and make policy prescriptions robust to economic and political uncertainty (see, e.g., Caballero 2010). Acemoglu and Robinson (2013) provide a recent illustration. These authors argue it is necessary to take into account future political equilibria when addressing current market failures. That is, economic reforms may be sensible from an economics point of view but could actually reduce economic efficiency when including dynamic political economy considerations in the analysis. As an example, the authors describe how the Russian privatizations of the early 1990s dramatically shifted income distribution towards an economic elite and gave rise to significant political changes and a backtracking of the reform process.

Furthermore, Deaton (2010) notes that for empirical research to be useful for policy analysis, it needs to be embedded in theory that explains the underlying mechanisms. In some reform areas theory is well established with broad expert consensus on what works. Khemani (2017) highlights macroeconomic stabilization and fiscal adjustment as examples. The large evidence base in these areas may explain why support for economic reform has generally been found to be successful.

In other reform areas—such as public-sector governance—credible evidence to design sound policies is often lacking (World Bank 2012). Public sector reform requires a deep understanding of local context and behavior, without which reforms may fail. For instance, human decision making relies on mental models through which information is processed. Often it is assumed that these underlying mappings of the world are correct and universal. Yet, the mental models individuals use to process information are the result of cultural heritage and encountered problems, and hence tend to differ (North and Knight 1997). Not considering the possibility of faulty mental models can hamper policy effectiveness. For instance, Harun (2007) notes that senior civil service officials in Indonesia are reluctant to embrace new accounting standards since they share the opinion that "what worked before will continue to work in the future".

Andrews (2009) distinguishes between public sector reforms involving relatively "concentrated" and "deconcentrated" sets of actors. Successful implementation of reforms is more difficult when it requires changing the behavior and norms of larger and more disparate groups of (public) agents (cf. Dixit 2003). For example, Khemani (2017) notes that stable norms of non-cooperation in society explain why reform efforts by powerful leaders to reduce corruption often fail. Khemani (2017) argues that legitimacy is needed to accept new norms of behavior. A quote from the Italian political scientist Gaetano Mosca reinforces this point:

> "It has happened in the limited number of societies that arrived at a certain level of development, that the political class does not exclusively justify its power solely on the grounds of possessing it, but seeks to give it a moral or legal basis, making it originate as a necessary consequence of beliefs generally recognized and accepted in the society (Mosca 1939)."

Since norms of behavior and cultural context differ from society to society (see, e.g., Platteau 2000; Mullainathan 2006; Cardenas and Carpenter 2008), it is important to customize external policy support and the evidence backing it, especially in reform areas where local context and behavioral norms play an important role. This implies that transplanting best practices to other cases may not always be a good idea (Rodrik 2008; Pritchett, Woolcock and Andrews 2013).

Finally, high-quality evidence is not only useful to show the distributional impacts of reform and to increase the demand for public policies, they also serve as an important input for the design and success of policy-based lending programs (Ravallion 2016). Deininger, Squire, and Basu (1998) empirically demonstrate that knowledge products improve World Bank project outcomes. Wane (2004) finds that analytical work and economic analysis have a large positive impact on the quality at entry of World Bank loans.[11] Smets, Knack, and Molenaers (2013) go on to show that the quality at entry of World Bank economic reform programs significantly increases the success of those operations. The authors also provide empirical evidence that resources are more productive—in terms of reform success—in the design of policy operations than in their supervision. Moll, Geli, and Saavedra (2015) investigate the impact of several design elements and find that development policy operations with evidence-based results frameworks perform better.

Changing Political Institutions

Policies are not only determined by beliefs and preferences, but also by the constraints provided by political institutions (North and Knight 1997). A large body of theoretical and empirical literature convincingly shows that institutions such as checks and balances on the executive or broad political representation promote investments in the common good, regardless of who holds power. This in turn incentivizes political leaders to build fiscal capacity and implement growth-enhancing policies (see Besley and Persson 2011a). Without such institutions inefficient policies may persist, as incumbents cannot credibly commit to not using their political power in the future (Acemoglu 2003).

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 1990s was heavily supported by Western countries (van de Walle 2001). Several strategies are employed to constrain policymakers and build commitment devices for enhanced policymaking. I argue in this section that supporting political change without taking into account general equilibrium effects can be counterproductive. It is important to realize that political institutions are not subject to linear change but are determined in a dynamic way (see Aghion, Alesina, and Trebbi 2004; Robinson and Torvik 2016).

I use the introduction of competitive elections and support for political parties as examples to illustrate this point.

Under ideal circumstances, 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, Stokes, and Manin 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, or even be counterproductive (Policy and Operations Evaluation Department 2012). Indeed, Chauvet and Collier (2009) find empirical evidence that frequent elections improve economic policymaking; however, this is not so in developing countries with low-quality electoral systems. The authors conclude that

> "For international policy to promote development the results have an important, if uncomfortable, implication. It is widely accepted that good economic policy is critical to successful development. […] Our results suggest that the route to policy improvement is through accountability of governments to their citizens through proper elections. To the extent that this process has failed it is because governments have subverted the electoral process […] Clearly, where governments steal elections by resort to illicit means citizens are powerless other than by themselves resorting to illicit methods of opposition. The task for the international community is thus to promote the effective accountability of government to citizen (Chauvet and Collier 2009)."

Furthermore, Collier and Vicente (2008, 2012) show that in "bad environments" voter intimidation, ballot fraud, and violence are used as strategies to affect voter turnout and influence electoral results. Another example comes from the Ivory Coast. After the 2010 elections, Laurent Gbagbo refused to step down despite the fact that the Electoral Commission declared Alassane Ouattara as the winner. Part of this deadlock was caused by the Constitutional Council's ruling that the elections were marred with massive fraud. Gbagbo repeatedly referred to the (questionable) ruling as a justification to stay in power.

Political parties have the potential to play an important role for a country's development (see, e.g., Huntington 1968; Keefer 2011). However, Randall (2007) notes that in developing countries the impact of political parties in fostering democracy and developmental policy making is disappointing. According to the author, this is due to the fact that parties are weakly institutionalized, that is, do not function according to formal rules, are faced with low party loyalty, and low autonomy. Weak institutionalization is explained by individualistic party origins, severe clientelism and contextual factors such as the international pressure for democratization. Especially in Africa, Western support for multi-party elections meant that political parties had to develop with very short notice (Bratton and van de Walle 1997). Building a more effective party system with external support is difficult. For instance, Carothers (2006) fails to find consistent evidence that external support for building developmental political parties has been effective, and stresses the need to study the local context before engaging in any type of assistance.

Discussion and Conclusion

Policies are not designed and implemented by a farsighted social planner but are determined through a political process, based on policymakers' preferences, beliefs, and the constraints provided by political institutions. Building on principal-agent theory, this study shows that without commitment on the recipient side, conditional financing is unlikely to induce policy reform. This begs the question of whether there is a need to review the way development agencies finance policy change.

As financial transfers in and by themselves are unlikely to be effective, are there other ways external agents can incentivize policymakers to engage in reform? Mattli and Plumper (2002) analyze the expansion of the European Union and suggest that accession to a club—partly driven by a sense of identification with core values—is an important stimulus for reform. Svensson (2003) and Zinnes (2009) propose aid tournaments where aid budgets are pooled and committed to a group of countries, with disbursements taking place based on the countries' relative performance.

While such proposals may seem hard to implement, some elements are already present in the World Bank's financing model for low-income countries. That is, the World Bank allocates its concessional funds based on each country's performance in implementing policies that promote economic growth and poverty reduction. Properly piloting and evaluating new incentive mechanisms within that framework may eventually lead to high development returns.

Relatedly, one may wonder whether it is advisable to combine two objectives—providing predictable budget financing on the one hand, and supporting policy reform on the other—in one instrument, as with development policy loans. The danger exists that recipient countries may run out of (politically) feasible reforms (Eifert and Gelb 2006). When that happens, development agencies may still want to close the financing gap by providing budget support but include policy conditions that have a negligible reform impact (World Bank 2018). Such potential trade-offs need to be taken into account. On the other hand, it is important to note that the provision of financing acts as a signal of credibility for financial markets and international investors (Clemens and Kremer 2016). Furthermore, financial support allows external agents to buy a seat at the policy dialogue table. So, while budget support funds do have a role to play in the policy reform process, it is necessary for external agents to be aware of and manage potential risks.

When acquiring a seat at the policy dialogue table, this study argues that external agents need to find ways to detect the beliefs that policymakers hold and be able to persuade government officials to change inaccurate attitudes. While theoretical and methodological advances have been made to elicit beliefs in laboratory settings (see, e.g., Schlag, Tremewan, and Weele 2015), finding out the views of policymakers during policy discussions may not be straightforward. Furthermore, as beliefs may be resistant to many forms of information, external agents need more than evidence alone to convince policymakers. Exploiting non-informative dimensions of influencing—for example, a common work history or the persuasive power of trusted experts—may help. Furthermore, development agencies often organize study tours to expose recipient country policymakers to new environments. Recent research by Stegmann (2018) indicates that such approaches may indeed help in transforming values and beliefs.

A proper focus on beliefs and influencing—which is currently lacking in many development organizations—also has implications for who takes a seat at the policy dialogue table. Indeed, policy discussions are often led by technical experts. Such competencies are essential, but they need to be complemented with a different set of skills that allow one to gauge beliefs and tap into the non-informative dimensions of influencing. Therefore, reform teams need not only include topical experts, but also persons with the proper "soft skills".

In addition to the appropriate skills, external agents also need to bring sound evidence to the table about the costs and benefits of policy reform. Even though new information may not always be effective in shifting policymakers' mindsets, it could reduce uncertainty about the distributional impacts of reform and help in identifying high-value public policies. Knowledge products also serve as an important input for the design and success of policy-based lending programs.

Credible evidence needs to be based on high-quality research designs, while the resulting policy prescriptions need to be robust to economic uncertainty and adapted to local context. However, all too often evaluations of development projects—which serve as an input in the design of new operations—are based on unrealistic assumptions, which indicates a need for methodological improvement (see Raifman et al. 2018). More broadly, Ravallion (2016) notes that World Bank spending dedicated to research has declined over recent years and is increasingly based on trust fund money. This author also points to a disconnect between the supply and demand of knowledge products within the World Bank. To ensure that policy advice and lending programs are built on the best available evidence, there is arguably a need to reverse those trends.

Given the importance of inclusive political institutions, it may be worthwhile investing resources in changing the structure of the political system. However, even if distributional considerations are binding, supporting political reform without taking into account general equilibrium effects can be counterproductive.

So how then to support effective accountability of government to citizens without the danger of large, negative, unintended consequences? While Besley and Persson (2011b) note that more research is needed in this area, Khemani et al. (2016) offer some interesting insights. These authors' well-documented policy research report argues for the need to support political engagement and transparency initiatives that may cultivate and improve the quality of political engagement. The authors state that, combined, transparency and political engagement can not only hold political leaders more accountable, but can also improve the incentives, beliefs, and behavioral norms of elected officials and the electorate.

What the above clearly illustrates is the need for further research. First, it is necessary to investigate the different dimensions to influence policy reform—that is, contracting, beliefs, evidence, and political institutions—more deeply. For instance, while financial transfers are unlikely to incentivize policy makers, tournament approaches are suggested as an alternative. However, these ideas have not been put to the test. Future research may investigate the effectiveness of these and other modalities in supporting policy reform.[12] With respect to beliefs, a burgeoning body of literature shows that beliefs matter for policymaking and that they are potentially open to change. While that may be so, Della Vigna and Gentzkow (2009) note a lack of empirical evidence on how to influence policymakers and the role of persuasion in autocracies. Providing hard evidence on the impact of (informative and non-informative) persuasive efforts in relevant field settings may prove very valuable.

With respect to evidence, how can we leverage current research methods and develop new ones to design policies that are robust to economic uncertainty as well as adapted to the local context? Regarding political institutions, how can external agents support political reform while limiting negative unintended consequences? Khemani et al. (2016) highlight transparent information provision and citizen engagement, but they also note the need for further research. For instance, the electorate may be resistant to new information. Moreover, Mukand and Rodrik (2018) argue that political leaders may strategically influence the public's beliefs, which could limit the scope for external actors to strengthen transparency.

Next, there is a need to think more coherently about the four dimensions. For one, how to find out which constraints are binding? External agents may unsuccessfully invest resources in persuading a political leader to change policy, while all along vested interests—and not biased beliefs—prevent the political leader from taking any action.[13] To determine the margins for change—if any—useful information is needed on the policymakers' preferences, beliefs, and the strength of political institutions. Another question is how evidence and new information affect the political equilibrium. 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 may increase polarization and induce conflict.

Besides the dimensions discussed in this paper, other factors also influence policy choice. For instance, Banerjee and Duflo (2014) present several examples where policies emerge due to slack in the political game or accidental factors. Alesina and Guiliano (2015) discuss how other cultural traits—generalized morality, trust, family ties, and individualism—are related to policies and institutions. Passarelli and Tabellini (2017) show that political unrest—fueled by an emotional reaction to unfair treatment—influences policy. Khemani (2017) highlights the importance of legitimacy and citizen communication for reform success. Relatedly, Stromberg (2004) shows how the interplay between media markets and political competition shapes public policy. Mukand and Rodrik (2018) demonstrate how identity politics determines voter behavior and policy choice. Future research should investigate the extent to which external actors can build on these factors to successfully support policy reform.

To conclude, this study has argued that external agents must pay proper attention to the nature of policy dialogue and quality of engagement with government.[14] Given the importance of political institutions, there is also continued need to find effective ways to make politics work for good policies. Finally, as research continues to enrich our understanding of the determinants of policy choice, external agents need to be prepared to act on those findings and expand the instrument set available to support policy reform in recipient countries.

Notes

Lodewijk Smets is an affiliated researcher at the LICOS Centre for Institutions and Economic Performance, Economics Department, KU Leuven, Belgium. This paper is the result of a long journey that started when I began my doctoral studies in 2008. I would like to thank everyone who was involved in that process, including—but not limited to—PhD supervisors, co-authors, seminar participants at various conferences and the three referees of this journal. All views and errors remain my own. Correspondence to be sent to: lode.smets@kuleuven.be.

1. The Economic Freedom of the World (EFW) Index ranks countries based on five policy dimensions: government consumption and taxation, policies and institutions related to rule of law, monetary policy and inflation, trade policy and factor market, and business policies (see Gwartney, Lawson, and Hall 2015 for more details). While the EFW Index represents a specific view on what constitutes good policy, it is highly correlated with other measures of institutional quality such as the World Bank's Country Policy and Institutional Assessments ($r = 0.63$) or the Heritage Foundation's Index of Economic Freedom ($r = 0.85$). It is important to note, however, that this study does not attempt to identify which specific policies bring countries to the economic frontier, but rather how external actors can support reform processes.

2. This study analyzes policy reform support through the lens of development assistance, with a specific—though not exclusive—focus on the World Bank. However, much of the discussion also applies to other producers of policy advice, such as research institutes, consultancy firms, universities, etc.

3. Many factors may explain differences in results between studies, among others the choice of estimation method, the country sample, the period of analysis, and the variables of interest. The empirical papers reported here generally cover a representative sample of low- and middle-income countries and estimate the impact of aid on policy quality using similar econometric techniques. Thus, the mixed conclusions are arguably not driven by these factors. It is important to note, however, that the papers do typically differ in terms of the period of analysis and the type of aid analyzed—that is, ODA, multilateral aid, World Bank DPLs, or technical assistance. While it is beyond the scope of this study to elaborate on how these factors may matter (see Clemens et al. 2012 or Smets 2016 for more details), we do report these dimensions in the text for clarity and ease of interpretation.

4. See Smets (2018) for a formal model on how these factors matter for policy reform support.

5. Alternatively, policy dialogue may affect behavior independent of beliefs, where non-informative factors of communication result in preference change. See Della Vigna and Gentzkow (2009) or Petty and Cacioppo (1986) for an overview of preference-based models of persuasion.

6. Strategic ignorance involves the avoidance of new information sources to protect valued beliefs; reality denial is the selective and distorted interpretation of new information to fit one's prior beliefs; and self-signaling corresponds to agents producing desired information themselves to reinforce certain beliefs (Bénabou and Tirole 2016).

7. Confirmation bias is a tendency to interpret information in a way that confirms one's prior beliefs.

8. As an example, Mullainathan, Schwartzstein, and Shleifer (2008) refer to Arnold Schwarzenegger's speech at the Republican Convention defending free trade policy. Schwarzenegger framed trade as a war where countries either win or lose. Using this frame, he transferred America's propensity to be victorious onto trade, claiming that America will win the trade war.

9. This is especially relevant for multilateral development banks such as the World Bank or the Inter-American Development Bank where many former staff members occupy senior policymaking positions in their home countries (e.g., Sri Mulyani or Ivan Duque).

10. Note that in practice even the most refined methods are not necessarily free from problems. Invariably, statistical techniques are based on assumptions to draw inferential conclusions. For instance, for IV techniques to be valid, the instruments employed need to be exogenous, that is, 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 be 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. According to Manski (2011), policy analysis is often based on strong but incredible assumptions. As an alternative, the author suggests using layered policy analysis that starts with weak but credible assumptions and then moves to findings based on stronger, less credible ones.

11. Quality at entry refers to the extent to which the World Bank identified, facilitated preparation of, and appraised the operation such that it was most likely to achieve planned development outcomes.

12. While not explicitly addressed in this paper, other features on the side of the external agent may also prevent policy reform support from being effective. It is well-documented that powerful donors strategically influence the decision-making processes at international financial institutions (see, e.g., Kilby 2009). Bilateral aid development assistance is also partly driven by strategic and political considerations (Alesina and Dollar 2000). Next, external agencies are often faced with spending pressure, which might endanger the longer time frame needed to provide context-specific policy advice (Svensson 2006). As promotion in IFIs tends to be based on loan approval rather than loan quality, the design of policy-based operations may suffer. In addition to extrinsic incentives, intrinsic, psychological factors such as biased beliefs may also prevent accurate policy advice from being generated (see Banuri, Dercon, and Gauri 2017). Thus, research is needed to investigate what organizational structure on the side of the external agent is most conducive for supporting policy reform.

13. I thank one of the reviewers for highlighting this example.

14. Recent empirical evidence indeed seems to suggest that the process of policy engagement is more important than the number of conditions or financial arrangements that come with it. For instance, Moll and Smets (2018) econometrically examine the impact of World Bank conditionality on the

quality of economic policy and find that the exact number of policy actions makes no difference to the quality of economic policy, while the fact that there was at least one policy action does make a significant difference. The authors interpret this finding to mean that the process of generating economic reform results in improved quality of government policy. Giordano and Pagano (2017) regress the "doing business" indicator on the cumulative number of DPLs and their cumulative value, and find that only the number of loans come out significantly. The authors derive from these results that overall engagement with the World Bank is more relevant than the amount of resources invested.

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