



Moving to private sector led growth: lessons from economic liberalisation

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Question

What do we know about the optimal sequencing and timing of reforms for countries seeking to shift from a public to private sector-led growth models? Pay particular attention to how countries have managed subsidy reform over a sustained period of time. Include examples of countries that have successfully done this.

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1. Overview

Countries shifted to private sector led models through policy and structural adjustments which liberalised their economies including trade. Since the 1970s, and more significantly since the 1980s, there has been a widespread shift towards liberalised economies, driven by a mixture of evidence, ideology and economic crisis. Given the number of developing countries that shifted to a more liberalised economy occurred in the 1980s and 1990s, much of the literature draws on lessons from this period. This review therefore sought academic reviews of a number of studies, with a focus on more recent reviews but recognising many were carried out in the 1990s and early 2000s. Although the focus on reducing generalised subsidies has been relevant through this period, it does remain an area with the potential for significant reform, and therefore lessons and examples include more recent reviews.

Where well implemented, countries that shift to private sector led models, effectively through economic liberalisation, have seen increased GDP growth. This growth has also led to reductions in poverty. However not all reforms are successful; liberalisation can be associated with political instability and greater risk of facing economic crisis. In the majority of cases, economic liberalisation has been driven by fiscal and balance of payment crisis, particularly in Latin America as well as other developing countries. Eastern Europe and former Soviet states also shifted to different degrees from planned to market economies.

Shifting to private sector led growth leads to winners and losers. Understanding which sectors of the economy and society will be affected is critical to ensure supportive policies can be put in place to reduce the costs, especially on more vulnerable populations and relevant sectors of the economy. This is also important to manage the political support for reform. Although there is relatively limited evidence either way, there is a general assumption that women, on average, benefit from successful economic liberalisation through job creation and economic opportunities.

Sequencing and speed of reforms matter; however, there is no one-size fits all approach. This depends on the country context, including whether macro-economic stabilisation is also required, how strong a political mandate is, and what institutional capacity exists to implement reform.

Shifting away from general subsidies can be part of economic liberalisation efforts, reducing distortions, freeing fiscal capacity for targeted social protection and productive investments, as well as gradually reducing fiscal liabilities. As with wider economic reform, general subsidies require careful planning and communication of their sequencing and speed and can include remedial policies and well implemented targeted cash transfers.

2. Brief economics of private sector led growth

Moving to private sector-led growth, and therefore economic liberalisation, encompasses the processes, including government policies, that promote free trade, deregulation, elimination of subsidies, price controls and rationing systems, and, often, the downsizing or privatisation of public services (Woodward, 1992). Economic liberalisation is carried out on the premise it leads to greater allocative efficiency within the economy and more broadly through trade with other economies. Assuming no market failures including externalities, liberalised markets would lead to pareto-efficiency¹ (Begg et al, 1984). Begg also notes the counter-argument is that liberalisation may lead to a once off efficiency gain, but does not necessarily lead to improved productive efficiency, where a country is moving towards its production possibility frontier² and therefore benefit from sustained economic growth.

3. Review of the main policy considerations

The context behind shift to economic liberalisation

Starting in the 1970s, and accelerating in the 1980s, there has been a shift towards increased liberalisation and private sector-led growth through more open economies. Drawing on conclusions by Simmons et al 2008, this has been driven by a range of factors, including from shifting geo-politics (end of Cold War) with the associated shift to pro-market ideologies (from monetarism to glasnost); and the chronic fiscal deficits, debt or balance of payment crisis (leading to crisis and structural adjustment in many developing countries)

Developed nations have also further liberalised their financial and trade sectors, as well as also carried out significant privatisation programmes. Definition of what economic liberalisation means will of course vary, and indexes such as the one produced by the Heritage Foundation of Index of Economic Freedom³ illustrates that, as defined by the Heritage Foundation, generally developed countries have greater economic freedom, while poorer countries tend to be “less free”. Although economic freedom and development does not confirm causality, the literature generally finds that economic liberalisation can lead to increased growth; even if this is not always a given (UN, 2010, ch 6).

Fiscal deficits

Fiscal deficits are often a political economy motivation for moving to private sector led growth. Lal (1987, pg 273) draws on lessons from the early 1980s, noting the role of fiscal deficits and balance of payments, especially in the context of a fixed exchange rate, as drivers of the political economy that triggers the shift to greater liberalisation of the economy including stabilisation through reduced fiscal deficit.

Economics policies emerging from the Latin American debt crisis of the 1980s, broadly expressed as the “Washington Consensus” (Dom and Miller, 2018), tend to conclude the

¹ An allocation is Pareto-efficient for a given set of consumer tastes, resources, and technology, if it is impossible to move to another allocation which would make some people better off and nobody worse off (Begg et al, 1984, pg 325).

² The production possibility frontier shows the maximum quantity of one good that can be produced given the output of the other good, defining output combinations that are production efficient (Begg et al, 1984, pg 397).

³ <https://www.heritage.org/index/ranking>

reduced fiscal deficits are required for successful transitions to more open economies. With Dom and Miller also noting the fiscal impact of liberalisation can be challenging as shifts to Value-Added tax (VAT) and other forms of revenue collection can be difficult for countries with weaker institutions. From a growth perspective, Marangos J (2003, pg 449) draws on the experiences of former Commonwealth of Independent States as they shifted from command to market economies, that fiscal deficits are important given their role in reducing the negative impact of the costs of transition.

Financial markets

Johnston and Sundararajan (1999), describe financial market liberalisation as:

- liberalising interest rates, market-based monetary control procedures, increased central bank autonomy;
- developing the banking sector through sound credit regulations, strengthening weak financial institutions, prudential regulations;
- development of money and interbank markets; and
- development of long-term capital markets and foreign exchange markets.

Johnson (1994) notes that the speed at which liberalisation of the financial markets takes place should consider the level of distortions (and associated parallel markets) as well as the level of domestic savings. Countries where significant parallel markets exist, and where financial repression has led to low domestic savings tend to benefit from a more rapid liberalisation (e.g. Latin America), while liberalising countries with high savings rates (a number of Asian countries) may liberalise more gradually. Khatkhate (1998) notes that a critical mass of bank restructuring and prudential supervision is required to then allow the liberalised development of the financial markets, reducing the risk of macro-economic losses and crisis.

Exchange rate policies

The exchange rate policy can and does have a direct impact on market signals, affecting producers, consumers, importers and exporters. It may also affect the government and private sector's ability to finance debt where significant debt is in foreign currency. Guzman et al (2018) note that the role of exchange rate policies for economic development is still largely debated; however, conclude that a stable and competitive real exchange rate may promote economic development.

Based on a review of the current literature, Ferrand (2018) concluded while it was important to have and maintain a credible exchange rate policy, policy decisions around fixed or pegged versus floating exchange rates were context specific. Moderately overvalued currencies could benefit investment and productivity through increased affordability to capital goods; while moderately undervalued can in some cases support export-led growth. Policy decisions would need to factor in the development stage a country is at, the foreign exchange flows and pressures it is facing, and the appropriate balance between domestic led and export led growth.

Foreign Exchange flows: capital and current account liberalisation

Adapted from Maehle N et al (2013), exchange rate policies in closed economies tend to control flows of funds and capital into and out of the economy. This can be particularly important where

trying to manage a fixed exchange rate; or maintain a degree of stability in a floating exchange rate as smaller economies can see major shifts in their exchange rate where foreign exchanges flow into, or out of, their economy. However they are often also characterised by parallel markets and foreign exchange rationing. Liberalisation allows markets to access foreign funds in the market, access international investment and credit lines, provides foreign investors the confidence they can transfer profits or sold investments out of an economy.

Development of the domestic financial market prior to liberalisation allows greater absorption and more effective allocation including capable oversight from the Central Bank. Conversely, devalued capital market liberalisation reduces access to international financing and know-how associated with Foreign Direct Investment (FDI). Eichengreen et al (1999) conclude that capital market liberalisation can take place over an extended period, ensuring this does not outpace the corresponding domestic liberalisation. The IMF (2001) concluded that most countries that avoided a crisis after opening capital flows had a sound financial system already in place.

Trade policy

Trade liberalisation is generally found to increase growth and consumer welfare. Estevadeordal and Taylor (2013) carried out statistical analysis of multiple countries over extended periods (to avoid bias that business cycles may cause), concluding a clear positive impact from significant reductions in tariffs on capital and intermediate goods. They found that countries that had liberalised these imports had a GDP/capita between 15-20% higher in 2004 than those that had not, relative to the base year of 1975. However, they also noted that not all tariff reductions should be expected to increase growth: reducing tariffs on final consumption goods increase economic welfare, but not necessarily potential growth.

Consideration for the fiscal impact may be relevant. Using panel data from eighty developing countries covering 1970 to 1998, Khattry and Rao (2002) found that trade liberalisation did lead to fiscal challenges as a result of falling incomes and trade tax revenue; and associated this to limited capacity within countries to shift from trade related to domestic tax sources.

Similarly, it is important to ensure the correct price incentives are in place. There is strong evidence of the benefits of initial macro-economic stabilisation and having an appropriate exchange rate policy in place before embarking on trade reform (Rodrik, 1992), as, for example, inflation and exchange rate shifts can significantly distort relative prices.

Sequencing and speed of reform

As described by Roaf et al (2014), sequencing and speed of reforms reflect the order in which reforms take place, and how quickly. “Shock” approaches reflect rapid liberalisation processes; “gradual” is both spread out over a long period and sequencing of reforms of implemented in stages (i.e. liberalisation of financial sector, labour markets, fiscal reforms, exchange rates, trade).

Nsouli et al (2002) note that proponents of both the shock and the gradual approach base their arguments on the lower adjustment costs. In a review of evidence drawn primarily from reforms in Latin America and Eastern Europe, as well as eastern Asia, they reflect that reforms contain four main features:

- Adjustment costs: where rapid reform can lead to a faster reallocation of resources that is productively efficient; while gradual approaches reduce short-term costs and lower political opposition.
- Credibility: full-scale reforms can be better established if done quickly; while credibility can be built up slowly if initial reforms demonstrate favourable benefits initially.
- Feasibility: as getting the sequencing right is challenging, a shock approach is more appropriate; conversely reforms take time as does managing competition between instruments⁴.
- Risks of other approaches: if not done rapidly, reforms may remain partial, resulting in reduced output and welfare as fail to create efficient markets; while gradual approaches reduce the short run increase in unemployment (leading to reforms being abandoned) and also reduce the risk of contagion from exogenous shocks.

Nsouli et al (2002) also reviewed sequencing lessons from developing and transition economies, drawing on a range of academic reviews. While fiscal and monetary stabilisation are generally seen as the initial step along with institutional reforms (where relevant), followed by liberalising the domestic financial system as well as domestic product markets (removal of prices controls, potentially subsidies, liberalise the labour market). The sequencing of privatisation, trade and capital flow liberalisation are significantly more debated with different arguments and experiences.

What success has looked like

Success is more commonly described as an increased rate of growth in GDP or GDP per capita. Concerns over inequality and poverty impact tend to be reflect concerns over the negative impacts for some sections of the population, which can also be associated political destabilisation more broadly. Higher economic growth is generally assessed to be positive for all income quintiles.

GDP growth

Based on a sample of thirty emerging and frontier markets, drawing on data from the late 1980s and 1990s, Bekaert and Harvey (2001) found that liberalisation of markets, specifically the financial markets, could explain between 0.7 to 1.4% GDP growth per year. In a review of a range of studies also covering more recent work, Irwin (2019) concludes that, on average, GDP growth post liberalisation is roughly 1.0 to 1.5% higher than a benchmark after reform (with a focus on trade reform).

Conversely, Hausmaan et al (2005) concluded from eighty episodes of rapid acceleration in economic growth covering sustained periods drawing from data between 1957 and 1992, only 20% were preceded or accompanied by economic liberalisation. Wacziarg and Welch (2008) find overall strong relationship between liberalisation (especially trade liberalisation) and growth on average, with the benefit being higher in the 1990s than in the 1960s and 1970s. However, they also find that around half the countries reviewed did not benefit from liberalisation. They explained this noting that “countries that experienced negative or no effects on growth tended to

⁴ For example, maintaining a competitive exchange rate to encourage export led growth may “compete” with liberalising current and capital accounts (as this can lead to significant inflows of forex)

have suffered from political instability, adopted contractionary macroeconomic policies in the aftermath of reforms, or had undertaken efforts to counteract trade reforms by shielding domestic sectors from unnecessary adjustments” (Wacziarg and Welch, 2008, pg187).

Poverty

Winters and Martuscelli (2014) in reviewing recent literature concluded that economic liberalisation generally boosts income and so reduced poverty. Economic liberalisation does impact on poor households in different ways, which can have negative as well as positive results. There can be increased wage inequality, though most research does find poor households are not worse off. Generally, they concluded that women are found to gain from liberalisation in terms of economic opportunities.

Minot et al (2010) of IFPRI, drawing on household data and using computable general equilibrium (CGE) modelling, reviewed the impact of trade liberalisation on Egypt, Morocco, Syria and Tunisia and found that liberalisation of agricultural sector did not impact on poverty levels. They concluded that the benefits to consumers outweighed the investments to support domestic producers through extension, information, disease control and social safety nets.

4. Price subsidy reform

Aside from the fiscal cost, general subsidies are generally found to be highly regressive. Del Prado et al (2012) in reviewing twenty developing countries found that on average, the top income quintile receives six times more subsidies than the lowest quintile for fuel subsidies. In some regions, energy subsidies in particular are very substantial, Clements et al (2013) calculates that in the Middle East and North Africa region an estimated 8.6% of regional GDP is allocated to these subsidies. In addition, some countries also provide significant food subsidies of over 2% GDP, for example in Egypt, Syria and Iraq (Sdradevich et al, 2014).

Gupta et al (2000) reviewed lessons from general subsidy reform in twenty-eight developing and transition economies, identifying some key considerations:

- Speed of subsidy removal: these can be more rapid where there is an electoral mandate (e.g. new government), in cases where the benefits are captured by a relatively small group or sector, or during favourable exogenous circumstances such as low prices for imported staples or fuel.
- Administrative capacity and social protection mechanisms: shifting to more targeted approaches through social protection require systems already being in place, which can then be adapted and expanded.
- Political support: without political support, this can lead to reforms being stalled or reversed.

They also concluded that:

- Large budgetary savings were difficult to achieve, especially in the short run.
- It was important for governments to develop and make public a detailed timetable of reform measures, which are well communicated.

- Rapid reforms are only effective where there is strong political support and acceptance of the social costs; or during favourable exogenous conditions such as low prices of subsidised imports.
- Social protection mechanisms need to be in place, reaching both more vulnerable but also considering politically vocal groups. In some cases, self-targeting may be appropriate through subsidies of lower quality goods (e.g. flour with unattractive packaging, lower quality rice).
- Risk of political disruption are highest when attempted without credible social protection mechanisms and the government is unpopular; a stakeholder approach to reform seeking to avoid undue burden to specific groups and mass information campaigns clearly explaining the benefits of reform also helped manage this risk.

5. Case studies and lessons

Market liberalisation

Corbo and de Melo (1987) review lessons from the initial liberalisation experiences of the southern Cone countries of Argentina, Chile and Uruguay. All three faced severe economic crisis including high inflation by the early 1980s, and had implemented very significant trade restrictions effectively since the 1930s. In this context, stabilisation is concluded to be particularly important, preceding liberalisation where inflation is high, and simultaneously where inflation is moderate. In all cases, a realistic and stable real exchange rate is also a clear lesson.

It is in the 1990s where the region starts to benefit from higher growth, with Loayza and Palacios (1997) concluding this is most promisingly driven by trade liberalisation and general improvements in areas such as sound policies, public administration, financial sector development.

Uruguay

Uruguay's example is one of gradual liberalisation, sensitive to social consensus. An UNCTAF (2015) study reviewed the impact of this experience from 1974 onwards, with a gender lens;

- Trade was gradually liberalised from 1974 onwards; reducing import tariffs and removing disincentives to exports. This led growth in the service sector; and strengthening of the export-oriented agricultural sector; with a steady reduction in manufacturing.
- Reforms have been driven by economic crisis (emerging markets debt crisis of the 1980s, contagion from Argentina's financial collapse in 2001), but also a series of democratically elected governments seeking to diversify the economy and reduce vulnerabilities.
- Fiscal deficits have remained relatively high, resulting in the challenge of inflation albeit greatly moderated since the 1980s.
- The major state-owned enterprises were not privatised due to popular resistance (energy, water, communications), confirmed in a national plebiscite. These were then reformed to be managed more effectively and profit making (albeit benefiting from monopolistic markets).

- Investment, including FDI, is an area where an increase (as a percentage of GDP) would be beneficial, FDI has been increasing since 2003.
- Percentage of adult population in employment has grown in the last three decades; driven by female increased labour participation.
- Social transfers are significant, traditionally through the universal pension system and more recently complemented with vulnerability-targeted cash transfers. Combined with increased female labour participation, extreme poverty is negligible and poverty rates have been greatly reduced.

As a complementary analysis, the IMF (2019), as well as the Economist (2018) concluded that Uruguay's strong growth record was associated with strong institutions, with associated strong economic policies. Exports and destinations have been diversified, debt has been managed prudently and external financing needs are pre-financed. Government has invested in raising productivity, investing on science and technology. The judiciary is kept independent from political interference.

Chile

The experience of Chile offers a relevant comparator, shifting more aggressively to a liberalised market from the 1970s onwards, and continues to have a strong market-oriented approach complemented with strengthened focus on social sectors.

- The very rapid liberalisation, including privatisation, between 1973 and 1975 led to a very significant fall in GDP/capita, followed by rapid recovery and a second, deep, recession in 1981-2 (Latin American debt crisis).
- However, since the 1980s, Chile has seen strong GDP/capita growth, and sought a more inclusive while liberal economic policy, with a "golden period of growth" seeing average annual GDP growth of 7.6% between 1986 and 1997, although Schmidt-Hebbel (2006) observes this also reflects recovery after a deep recession and period of favourable terms of trade for exports.
- Institutional shifts have been important; Corbo et al (2005) estimated that at least 20% of this growth was directly attributable to institutional strengthening, including voice and accountability and significant reduction in corruption, with additional significant growth-related gains indirectly attributable through improved policy-making. Gallego and Loayza (2002) using international panel data, find that between 45% and 75% of Chile's post 1985 growth is explained by the contribution of policy interactions as the most influential growth determinant (institutions, sound policies).
- Similarly, Corbo and Schmidt-Hebbel (2003) argue that policy reform, in particular fiscal and financial reforms, as well as privatisation, were critical for the positive and significant contribution of pension reform to growth in Chile (which reduced future public liabilities and created increased domestic savings available for investment).

Both Chile and Uruguay have successfully modernised their economy since the 1970s, leading to sustained average per capita growth from middle income to high income economies, taking turns to have the highest per capita GDP in South America in the last three decades⁵. Chile is

⁵ <https://datos.bancomundial.org/indicador/NY.GDP.PCAP.CD?end=1995&locations=UY-CL&start=1966>

perceived to be more progressive in terms of economic opportunities, with significant free trade agreements and larger economy, while Uruguay is perceived more equitable and progressive⁶.

Turkey

Turkey carried out extensive economic reforms 1990s to mid 2000s. Anand et al (2013) summarised Turkey's successful energy sector deregulation and price liberation in the 1990s to have been possible due to the success of wider economic reforms that received broad public support in the context of higher economic growth and falling inflation. Targeted social safety nets were also scaled-up.

In a comprehensive World Bank (2014) report, the following reforms are considered part of Turkey's economic transition:

- **Trade liberalisation:** initial liberalisation was supported with subsidised export credits; allowing a rapid expansion in medium-technology exports. This was further strengthened through a customs union agreement with the EU, investments in logistics and diplomatic outreach to support the diversification of Turkey's trading partners.
- **Finance:** a strong regulatory and legal framework, supporting greater transparency and accountability, allowed a turn-around of the banking sector.
- **Enterprise:** improvements in the business environment, including increased investment on transport and communication and flexibility in the labour market which was backed by strong investments in health and education improving human capital.
- **Infrastructure:** increased efficiency of investment in infrastructure, drawing in private investment alongside public investment.
- **Public finance:** this shifted to prudent fiscal management including a steady reduction of general subsidies, reducing public debt/GDP, introducing public finance management that reduced patronage-based spending and expanded the revenue base.
- **Institutional performance:** institutions and public sector governance significantly improved in the 1990s to mid 2000s.

India

India's approach has been one of gradual market reforms. Although China and the East Asian tigers offer cases of faster growth; India provides an example of a more gradual, partial, complex process where institutions and political interests are always clearly aligned.

Ramaswami et al (2011) conclude that there was evidence of structural break associated with the initial economic liberalisation, which led to a higher sustained GDP growth rate occurred around 1980, although note that agriculture was early (1960s with the "green revolution") and manufacturing somewhat later (1982-83).

Explanations reflected by Ramaswami et al, drawing on a range of other studies conclude:

- The economy saw creeping liberalisation starting in the mid 1970s, and while piecemeal reforms, they were appropriate and moderate. The rate of GDP growth increased further after the liberalisation in the post-1991 period.

⁶ Author's views.

- In the earlier, more gradual stages of liberalisation (1980s), fiscal stimulus could have led to greater demand for goods and services, however a significant rise in factor productivity was also observed explaining much of the growth.
- Changing attitudes in the 1980s were thought to play a role, with a shift in political signalling as well as more broadly. Rodrik and Subramanian (2004) observed that India's economy was much smaller than its capacity suggested (factors of production and estimated production possibility frontier), concluding that a change in attitude could have a significant impact on actual output and GDP.
- Sen (2007) attributes significant increase in access to banks (driven initially by nationalised banking system being incentivised to rapidly expand into rural areas) enabled a very significant increase in household savings which in turn helped finance gross capital formation, including a shift to investment in capital goods (which in turn were made easier through partial trade liberalisation).
- Post-1991 growth was primarily driven by service sector liberalisation (telecommunication, financial sector, IT), which demand high skilled labour.
- Subsidies in rural sector increased through fertiliser and other inputs, done to targeting a more unskilled labour sector (who gained less from the mostly service-sector driven growth) as well as supporting private sector investment into agriculture – although poverty remains especially rural challenge and subsidies were often faced elite capture and corruption rather than reaching intended beneficiaries.

Subsidy reforms

Brazil

Brazil carried out significant liberalisation and associated reduction of generalised fuel subsidies. Anand et al (2013) found this was done gradually, helping ensure it was politically acceptable. Price deregulation started in the mid 1990s, and in the case of gas (LPG) prices (used extensively for cooking and heating in lower income households) this was accompanied with LPG vouchers being given to low income households. A nationwide targeted cash transfer programme was expanded, and consolidated under the flagship *Bolsa Familia* cash-transfers programme.

Iran

Iran more recently carried out significant reform of its fuel subsidies. With one of the highest percentage GDP subsidies on fuel in the world, and high levels of smuggling of cheap fuel out of the country, Iran in 2010 took steps to reduce general subsidies. Atansah et al (2017) concluded that key steps included:

- Mandate: the populist leadership entering government in 2009 promoting a pro-poor shift in subsidies; noting that the majority of the fuel subsidies benefitted the wealthy.
- Clear communications: this not only focused on the population in general, but the government also worked closely with the private sector and through analysis and consultation, included targeted subsidies to over 7000 enterprises to reduce the financial hardships of price increases.

- System to register and receive payments: registration was made easy for eligible households; bank accounts were made easy to open with support from officials, initial cash transfers were made before general fuel subsidies were removed, banks expanded the ATM system to be ready to manage the significantly greater demand for cash withdrawal.
- Most citizens were eligible for payment: given the very significant level of fuel subsidies (and so potential savings), this also allowed for wide coverage with associated political benefits. Efforts to gradually remove the better off beneficiaries were then put in place.

Benefits were significant, especially in reducing inequality and poverty. However, Iran's economic challenges, including continued high inflation, has meant energy subsidies have only been partially removed and the planned reform has not been fully implemented.

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