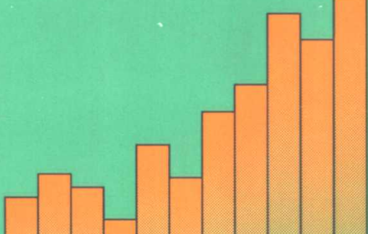
HARVARD STUDIES IN INTERNATIONAL DEVELOPMENT

REFORMING ECONOMIC SYSTEMS IN DEVELOPING COUNTRIES

EDITED BY DWIGHT H. PERKINS AND MICHAEL ROEMER



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Editors
Dwight H. Perkins
Michael Roemer

Copyediting and management
HIID Publications Office
—Thomas N. Gardner, senior editor
—Nancy Hamlin Soukup, assistant

Proofreading and editorial assistance
Christopher Malloy, Nicholas Philipson, Evelyn Rosenthal, Carol Schrader

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Introduction

Reforming economic systems has been at the heart of development since the 1950s. The specific content of reform efforts, however, has changed, often dramatically, over the years. In any given period there is typically a dominant point of view on what reforms best promote development. As efforts to implement that view unfold over a decade or more, the limitations of this dominant vision become increasingly apparent until a new, more complex reform model is brought to the fore. The old ideas are seldom totally rejected, but the simple formulas for growth that seemed to hold so much promise at the outset of a new reform period give way to others that appear to promise more in the way of growth and equity.

The dominant vision of the past decade and more has been rooted in powerful propositions of neoclassical economics: the core of reform efforts should be devoted to achieving development through competitive markets.

This neoclassical vision was itself a reaction to an earlier paradigm that stressed the importance of planning. Planning, it was then argued, was needed to overcome various market failures endemic to developing countries. Critics of this emphasis on planning initially argued that planners put too much emphasis on growth and too little on equity. The greater concern for equity that followed became the intellectual foundation for a whole new set of state interventions that were designed to correct for market influences assumed to be inequitable. It was against this background of two decades and more of state intervention in the economy that the neoclassical economists' view came to the fore. Neoclassical economists had little trouble finding numerous horror stories of state interventions that became the main source of market imperfections. If one could remove government intervention, markets would return to something more closely approximating perfection, and growth would accelerate. Even equity considerations might be better served because state interventions to promote equity quite often served the special interests of the wealthy and powerful instead.

There is little doubt that efforts to improve the functioning of markets in developing countries have had a positive impact on growth in recent years and may have had a positive impact on equity as well, although the latter point is hotly debated. But this neoclassical view has also been oversimplified and oversold. It has been oversimplified because its advocates have not recognized the full complexity of measures needed to make markets work well in a developing country after decades of massive state intervention. The neoclassical prescription has been oversold because it has sometimes been presented as the sole requirement to achieve development. Governments are not going to disappear in even the most market-oriented developing countries any more than they are going to wither away in the idealized state of pure communism. It is imperative, therefore, that reformers understand the role of government in promoting development: what it must do, what it can do effectively, what it need not do, and what it cannot do effectively.

The HIID Experience

The Harvard Institute for International Development (HIID) has been an active participant in the development process in more than forty countries over the past thirty years. In its earlier years, the Development Advisory Service (DAS), as the Institute was then called, was involved in strengthening the economic analysis of planning commissions in Pakistan, Colombia, Ethiopia and a half dozen other countries. DAS's involvement acknowledged that governments were inevitably going to be heavily involved in a wide range of development activities and that their personnel ought to be trained to carry out those functions efficiently. Ours was not an effort to promote planning over the market, but to do well whatever degree of planning and government policy intervention in the economy was deemed appropriate. The issue of equity versus growth was raised at an early date and played a particularly prominent role in the later stages of our involvement in Pakistan.

In the 1970s and even more so in the 1980s, HIID has shifted its efforts to help make markets work better. "Getting prices right" was a slogan that many outside of HIID, and some within as well, thought was virtually synonymous with the economics work of the Institute. To some, "getting prices right" meant little more than getting governments out of setting prices and letting markets do so unfettered.

Increasingly, however, the people in HIID working on economic systems reform—a group that includes anthropologists, political scientists, lawyers, management specialists, and economists—have recognized that our own work goes well beyond the neoclassical menu of reform. We have tried to convince governments to depend more on markets to promote development, but this has not meant a retreat for government out of the development business. Most often we have helped governments build their capacity to work through markets to achieve more rapid and equitable growth. The national and international aid agencies, who aggressively endorse the neoclassical prescriptions, also fund—and implicitly endorse—these efforts.

It became increasingly apparent to us that HIID had to have a clearer picture of what we were really doing to help reform economic systems. If we were to provide advice and training to others, we needed to better understand ourselves what the reform process involves. To that end, in 1988 we established a framework for analysis of various reform efforts and invited those in the Institute who were so inclined to write papers based on their research and their own experience with reform. Drafts of these papers were presented and discussed at an HIID conference held in Marrakech, Morocco, in November 1988, and after further revisions an appropriate subset of those papers was compiled for the present volume. These papers are based heavily on case studies of actual reform experience, in many instances reforms in which the paper authors themselves participated. Some papers deal with single instances of reform; others look at a number of cases in a comparative way.

What Does Reform Involve?

Reforming an economic system in the 1980s and 1990s does involve making markets work better. Most reforms are implicitly based on the proposition that high productivity growth is necessary to sustain rapid development. This proposition contrasts with the standard view in the 1950s that higher levels of capital formation are central to successful development. Neoclassical reformers further assume that competition stimulates productivity growth, a relationship that has not been well established empirically. Our introductory essays will explore the empirical foundations for this relationship a bit further, but for the moment we shall take it as a given.

There are three basic propositions about the nature of most reform efforts that will be stated in abbreviated form and then elaborated below.

1) Making markets work efficiently in developing countries is more complicated than textbook economic theory would lead one to believe. It is not that the textbooks are wrong. But they assume certain kinds of behavior and certain types of institutions that cannot be taken for granted in most developing countries. The typical industrial enterprise manager in a developing nation, for example, does not maximize profits in the face of output and input prices over which that manager has no control. More often than not that manager has a great deal of influence over the prices he pays and receives.

2) The state plays an active and essential role in the development process. One cannot treat the state as simply an impediment to the proper functioning of free markets. The real issue is not so much whether the state should be involved, but how state involvement should be handled. What are the rules or principles that should govern different kinds of state intervention in the economy? Put more generally, many economic controls are implemented by bureaucratic commands or rules rather than through market forces, but the development literature has relatively little to say about the principles that should underlie these commands and rules.

3) Technocrats may be inclined to ignore distributional issues, but no one else will. As a result, distributional issues play a pervasive role in economic systems reform. Rural people contend with the urban population over the price of food, and bureaucrats fight with each other over who should command what government resources. The success of any reform effort depends critically on how these diverse political forces are brought to bear. Analysts and practitioners of reform, therefore, must understand political economy and not just economics.

There is nothing surprising about these three propositions taken individually. Together, however, they provide a framework for the analysis of reform that is more complete and systematic than most of the formulas currently extant. Certainly catch words and phrases such as "privatization" or "getting prices right" deal with only one or another corner of the problem. The World Bank's concept of "structural adjustment" is more inclusive, covering a wide variety of specific reforms, but does not provide a systematic framework that indicates why some reforms are included and others are not.

Making Markets Work

Much of neoclassical economics is devoted to spelling out the price-setting rules that will maximize social welfare. When uncertainty or asymmetric information in principal-agent relationships is included, deriving the price rules that maximize welfare can become a sophisticated exercise in mathematical economics. In development economics, however, as Michael Roemer's essay points out, the dominant neoclassical view is that welfare-maximizing prices and free market or world prices are more or less synonymous. Deep down this is almost as much a political judgment as an economic one.

It is not that development economists are ignorant of the various studies that show how state intervention in the setting of prices can sometimes improve the welfare of a nation. But development economists feel that most states are incapable of implementing such rules. Private interests or political forces will always divert prices from the welfare ideal. Only a general rule, such as total abstention from state price fixing, the argument goes, is politically feasible.

Clearly, there is some truth to this point of view. Development specialists have an armory of examples of irrational price distortions. But although governments may be incapable of implementing sophisticated interventions, they are also politically unwilling to let prices be set wholly by the market. Almost all developing countries, including some very successful ones, regularly intervene in the setting of prices. South Korea, as Dwight H. Perkins's paper points out, is one among several examples.

The job of "getting prices right" should thus involve a more realistic analysis of how welfare-maximizing prices can account for distributional and political realities. Food policy analysis, as C. Peter Timmer's essay elaborates, does just that. Few nations can afford to let rice prices fluctuate with short-run world market forces, nor is there any reason why they should do so. It does not follow, however, that the state can interfere according to any criterion that catches its fancy. There are systematic ways of including both economic and distributional considerations, as food policy analysis tries to do.

Shantayanan Devarajan and Jeffrey D. Lewis stick more closely to pure economic analysis but make a similar point. In the real world of developing countries the standard rules of thumb of most development economists are based on economic models bearing little relationship to reality. In the second-best world of development, as a result, these price-setting rules of thumb can involve substantial departures from welfare maximization. Alternative rules, which Devarajan and Lewis spell out, come closer to the mark. It may be that these alternative rules of thumb are not readily implementable, but that is a political judgment, one to be faced explicitly and not buried in economic analysis purporting to be purely technical and politically neutral.

Getting prices right, though not an easy task, does have the virtue of being a goal where the tools of economic analysis, tempered with politics, are well developed and clearly useful. The same cannot be said for the second critical component of successful markets.

The pervasiveness of state involvement in the economy of most developing economies means that profit maximization by enterprises, particularly the larger ones, has little to do with such traditional market-oriented behavior as cutting input costs or increasing sales. Instead, enterprises spend much of their energy gaining subsidies or protected markets from the state. Subsidies and protection can take many forms, ranging from loans at below-market interest rates (loans that often do not have to be repaid) to import quotas that guarantee local firms monopolies.

This problem is apparent in the relationship between enterprises and the government bureaucracy in Bangladesh as described by Richard D. Mallon and Joseph J. Stern. Government officials intervene in enterprise decisions in

Bangladesh at every step from quotas on key inputs to soft loans from the state banking system. Entrepreneurship is as much a matter of manipulating state interventions as it is actually running the business itself. Inefficient enterprises can survive and prosper indefinitely on government largesse. Efficient enterprises that really contribute to Bangladesh's development are stifled or never allowed to get started. The dominant enterprises face what is known in the literature on Eastern Europe as the "soft budget constraint": they do not need to worry about keeping costs down because they can always get bailed out by the state if they run losses.

In Indonesia, as in Bangladesh, the state banks until recently were little more than subordinate units of the central bank and the Ministry of Finance. The main function of the banks, as described in the paper by David C. Cole and Betty F. Slade, was to channel funds from the government budget to other state enterprises. Bank losses, which were large, were made up by subsidies from the government. The banks, in effect, faced a soft budget constraint which in turn allowed them to provide a soft budget constraint to their borrowers, mainly the larger state industrial firms.

When enterprises and banks are maximizing profits through manipulation of their ties to government, even getting prices right will not necessarily increase welfare or promote development. Making markets work means, in these cases, breaking the connection between government and enterprises, creating hard budget constraints, and eliminating discretionary interventions by the state. That, in essence, is one key feature of financial reforms in Indonesia where the government is trying to turn the state banks into publicly owned but genuinely autonomous commercial banks. If the government efforts succeed, not only will the banks behave according to market rules, but enterprises that borrow from the banks will also have to become more autonomous as their managers pay more attention to cutting costs or increasing their sales to repay loans of commercial rates of interest. That is, all enterprises will have to behave in ways required by well-functioning markets.

A third component of effective markets is competition. Lack of competition is an acute problem in developing countries, where markets are often too small to sustain many firms in a single industry and import quotas are regularly used to enforce cartel-like arrangements. Import liberalization is one of the primary measures for promoting competition and, through competition, the more energetic pursuit of growth and efficiency by enterprises. Policies that promote small and medium scale enterprise development, as contrasted to large conglomerates, can also be a means for achieving more vigorous competition, as suggested by Tyler S. Biggs and Brian Levy in their essay comparing the industrial structure of South Korea, Taiwan, and the Philippines.

In industrialized countries, competition is fostered by legislation attacking restrictive business practices as exemplified by antitrust legislation in the United States. As Clive S. Gray's paper points out, however, few developing countries have such legislation and those that do often use it more to restrict foreign investment than to promote competition. A central issue is whether legislation can really limit restrictive business practices in developing countries or whether such rules will become another weapon in the bureaucrat's arsenal to make collusive arrangements with favored enterprises. Gray emphasizes an independent judiciary as one way to deal with this latter problem, but independent judiciaries are not the rule in developing nations. Creating strong legal institutions is one of the lengthy processes of development, not something that can be done as part of a short-term reform.

Finally, there must be some degree of macroeconomic stability if markets are to function properly. This set of essays is mainly about systems reform rather than stabilization, but the two subjects cannot be divorced. High rates of inflation divert investment into unproductive channels. If the price increases reach politically intolerable levels, and cannot be controlled by macroeconomic measures, the inevitable result is a proliferation of price controls leading to rationing, formal or informal, and a declining role for market forces. Balance-of-payments disequilibrium can lead a country down the same path. The Gambia in the late 1970s and early 1980s, for example, experienced both accelerating inflation and disappearing foreign exchange reserves. Borrowing postponed the inevitable, but, as Malcolm F. McPherson and Steven C. Radelet describe, by the mid-1980s the country was in a deep crisis with shortages everywhere and per capita income declining. Escape from macroinstability is seldom easy. For The Gambia a combination of political forces made possible a rapid economic turnaround within two years.

Making markets work efficiently, therefore, is a complex and difficult task in developing countries. Not only must one get prices right where prices have been subject to massive distortions; a reformer must also alter the behavior of enterprise managers often in quite fundamental ways. Autonomous enterprises must also be made or allowed to compete with each other rather than collude to control the local market. And all of this must be done within a stable macroeconomic environment. The more a country has departed from the rules of the market as a result of interventions in the past, the more difficult it is to bring market forces into play.

The Role of the State

Complex as it is, market reform is only one of three components of economic systems reform. Although market reforms suggest a lesser role for the state, any well-functioning economic system still requires a well-functioning government. The state performs two distinct functions related to economic development. First, it taxes and regulates economic agents. Second, it actively promotes development. There is an inevitable tension between government and the market because government generally operates through hierarchical systems of control, using bureaucratic commands rather than impersonal market forces.

All governments must tax their citizens and regulate some of their activities. How taxation and regulation are implemented are of central importance to how well markets will work. If government bureaucrats have a high degree of discretion, they will use taxes and regulation to bring enterprises under their control, moving the economy away from market forces. Glenn P. Jenkins's study of tax reforms around the world illustrates these issues. Tax systems have been used by countries to achieve a more equitable income distribution and to pursue any number of other social goals. But even in advanced industrial countries tax systems have often worked out quite differently from the intentions of their designers. In developing nations complex tax systems with highly progressive rates and a multitude of exceptions to general rules have been powerful weapons in the hands of government officials who wish to control the economy or line their own pockets. To avoid discretionary interventions tax systems must be as simple and have as many self-enforcement mechanisms as possible.

If the rules that should govern the state's tax and regulatory functions are relatively straightforward, the same cannot be said of the state's development role. The wide scope of state development activities, from infrastructure investment to public enterprises, is outlined in the paper by Dwight H. Perkins. The complexity of getting state enterprises to behave in a way that promotes development is illustrated by Donald R. Snodgrass and Richard H. Patten in their essay on the reform of one of Indonesia's state banks. It is also well illustrated in Thomas P. Tomich's analysis of why so much of Indonesia's tree crop development has been handled through large-scale block planting schemes that rely more on hierarchical command systems of control than on market forces. In the case of tree crops, there is a smallholder, market-oriented alternative that may be more efficient. But market alternatives may not exist for some state interventions or may not be politically acceptable.

Both state and private enterprise are usually managed through hierarchical systems involving commands rather than market forces. But the principles that should govern the operation of hierarchical systems in a state enterprise are very different from those in a regulatory agency. Maximum flexibility is required in the former and minimum flexibility in the latter. Maximum flexibility, however, requires that incentive systems within the enterprise be closely tied to the firm's objectives. Designing incentive systems that keep employees from going off in unproductive directions is a complex management task, as HIID's experience with reform in the Bank Rakyat Indonesia Project illustrates.

Hierarchical or bureaucratic command systems have been used to control entire economies. China before reform and the Soviet Union are extreme examples, but South Korea's economy in the 1960s and 1970s was run to an extraordinary degree by the commands of Presidents Park and Chun and those who did their bidding in various government bureaus.

The principles that should govern state guidance of the economy as a whole are probably very similar to those that should govern internal management in producing enterprises: clear and simple goals with incentives clearly tied to the achievement of those goals. This whole field of management of hierarchical systems within a developing country context is poorly understood, however, and most development agencies and academic institutions do not deal systematically with the subject at all. Our efforts in this volume point out the void but make only a few tentative steps toward filling it.

The Politics of Economic Reform

Politics enters at all stages and levels of economic systems reform. Even the most technical subjects, the setting of relative prices in a second-best world for example, turn as much on political judgments as on technical analysis. It is not good enough, as economists have typically done, to say that successful reform requires "political will." Such an assertion begs the question of why some leaders carry out clearly needed reforms while others do not. The will to reform is rooted in the values of a society, in the nature of its political and social institutions, and in the nature of the reforms being attempted. It is not simply, or even primarily, a question of individual psychology.

The essay by Merilee S. Grindle and John W. Thomas attempts to build on case studies of reform efforts to generalize about the political underpinnings of successful reforms. Their focus is on policy-making elites, including politicians representing broad class interests, bureaucrats fighting over their piece of government's turf, technical advisers both domestic and foreign, and even the officials of foreign assistance agencies. Which of these groups has the greatest influence on any given reform depends in important ways on the nature of the reform itself and the circumstances pushing a nation toward reform. Politics internal to the bureaucracy, for example, are most likely to determine the outcome of reforms that take a long time to implement, are technically complex to carry out, whose benefits are widely dispersed and not readily apparent to the beneficiaries for some time, and whose initial costs are born mainly by the government budget. Reforms that can be implemented quickly and are more or less self-implementing, as in the case of a devaluation or a change in food prices, are more likely to be fought out in the public arena among political leaders reflecting broad interest groups within the population at large.

It is no accident that much of the political economy literature to date deals with the politics of short-term stabilization efforts rather than with longer-term, more fundamental reforms of the economic system. The political forces surrounding short-term stabilizations are much more visible, making it easier to describe just who won and who lost, and how each of these winners and losers reacted. Most of the reform cases studied by Grindle and Thomas deal with long-term structural changes ranging from land reform in the Philippines to decentralization of decision making in Kenya.

Economists have attempted to approach the politics of reform through an analysis of the proper sequencing of different reforms, as Michael Roemer and Steven C. Radelet point out. Should quantitative restrictions on imports be removed before rationalizing tariffs? Should capital markets be liberalized only after trade liberalization has made substantial headway? Some of these issues are largely economic in nature. Trade liberalization without correcting for an overvalued currency, for example, will lead to a run on foreign exchange reserves and an end to liberalization efforts. But most issues of sequencing turn on the interaction of political and economic forces. Whether quantitative restrictions on imports or high and uneven tariffs on those imports should be reformed first is largely a question of which set of measures will generate the greatest resistance to further reform. Economists who attempt to deal with these sequencing issues without understanding the political forces at work are not likely to produce many useful guidelines for policymakers.

Finally, politics is deeply rooted in the domestic culture and history of a nation and, in some important cases, in the nation's international environment as well. No generalizations can fully capture the diversity of forces at play, and there is no short cut to a more profound understanding of any given nation's politics. The dominance of bureaucratic politics in Bangladesh is not simply the playing out of universal forces found in all countries. Bangladesh's bureaucracy and its army are among the few strong institutions in the nation, products of Bangladesh's relatively recent emergence as a nation from the tutelage of Pakistan