THE GRABBING HAND

GOVERNMENT PATHOLOGIES AND THEIR CURES

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1 Perspectives on Government

1.1 Three Models of Government

In the center of a nation's sprawling capital, the imposing tower of the country's largest commercial bank rises high above its neighbors. As is customary around the world, this bank is owned by the government. As is also customary, the bank is in deep financial trouble. Many of its largest borrowers have defaulted, often after a noisy public scandal. A would-be movie mogul, for example, has defaulted on a huge loan and has since been found guilty on criminal charges in the United States, jumped bail, and disappeared without a trace. Another major borrower jumped off his boat and drowned after a massive fraud was uncovered at one of his companies. Both of these customers of the bank had ties to the country's governing party at the time the loans were made. The bank's overall losses added up to $30 billion. Although many of these losses are explainable by poor lending decisions made as the bank tried to become the biggest on its continent, a large share of the losses has been attributed to fraud.

The bank's attempts to restore itself to financial health have not succeeded. The bank owned a large stake in one of the country's most profitable companies. But when the management attempted to sell the stake to the highest bidder, it was advised by the government to sell the shares to the company's founder at a quarter of the market price instead. The founder turned out to be a close friend of the country's president.

Where is this bank? It happens to be Crédit Lyonnais in France, a bank that has lost $30 billion while attempting to become the largest in Europe.[1] But this bank could be almost anywhere. Similar stories can be told about government-owned banks in dozens of other countries in Western and Eastern Europe, Asia, Latin America, and Africa.

One need not look only at banks. Enormous losses from bad decisions as well as fraud have bedeviled public enterprises around the world, whether they operate in industry, services, or transportation. A World Bank (1995) publication describes a Turkish state-owned coal-mining company that runs annual losses per worker equal to six times the per capita national income, a state-owned power utility in the Philippines that shuts off electricity for seven hours a day in many parts of the country, a state sugar-milling monopoly in Bangladesh that employs 8,000 unneeded workers while forcing the price of sugar in the country to stay at twice the international level, and a Tanzanian state-owned shoe factory which, with the World Bank's help, could not get its production to rise above 4 percent of capacity before eventually shutting down.[2] Nor does one need to stop at public enterprises when discussing the inefficiency of government performance. One can instead focus on overstaffed and inefficient agencies, fraudulent redistribution schemes, and corrupt judges and officials. Again, the universe of countries to draw on for examples encompasses most of the globe.

These ubiquitous public sector performance failures have called into question economists' conventional views of the state. Most significant, they have challenged the post–World War II advocacy of massive state intervention in markets to cure so-called market failures, based on what can be best described as the helping hand model of government (e.g., Musgrave 1959 or Stiglitz 1989). According to this model, unbridled free markets lead to monopoly pricing, to externalities such as pollution, to unemployment, to defective credit supply to firms, and to failures of regional development, among other ills. Solutions ranging from corrective taxes, regulations, and aggregate demand management to price controls, government ownership, and planning are then proposed to cure these market failures.

Although the helping hand model of government was initially conceived as a prescriptive model, describing what a welfare-maximizing government should do, it increasingly came to be used as a descriptive model, allegedly describing what actual governments do. Economists began to describe government regulations, government ownership, price controls, and other widely practiced interventions as actual responses to alleged market failures. Unfortunately, the helping hand model has failed as both a descriptive and a prescriptive model of government. It has failed as a descriptive model because governments pursue interventions such as state ownership and agricultural supports that serve their political goals and only occasionally coincide with social welfare. The helping hand model also fails as a guide to policy because it presumes that the government will maximize social welfare. Because of the falsity of its premise, this model's advice is often the opposite of what serves the public.

The traditional alternative to the helping hand model is the laissez-faire view of the state—the invisible hand model. This model begins with the idea that markets work very well without any government. The government may perform basic functions needed to support a market economy, such as the provision of law, order, and national defense. Other than delivering these few public goods, the less the government does, the better. The adherents of the invisible hand model rarely inquire what the reasons for massive government intervention in real economies are, or focus on the reforms that would contain the government.

Like the helping hand model, the invisible hand model of government was initially conceived as a prescription for an ideal, limited government. Its irrelevance as a descriptive model is quite obvious, since the government intervenes in economic life much more than any version of an invisible hand model would allow. This failure to deal with reality also renders the invisible hand model unhelpful for generating policy advice. Because it ignores politics, the invisible hand model does not come up with viable strategies for achieving its advocates' ultimate goal of limited government. In the more complex cases where the route to more limited government is indirect, the invisible hand model can offer genuinely harmful policy advice.

The third view of government—what we describe here as the grabbing hand model—focuses squarely on politics as the determinant of government behavior. The grabbing hand model shares with the invisible hand model a skeptical view of government, but describes more accurately what governments actually do and therefore focuses more constructively on the design of reforms. The grabbing and helping hand models share their activist interest in reforming government, although since their conceptions of government are so different, their ideas of good reforms rarely coincide. The grabbing hand analysis typically looks for ways of limiting government as opposed to expanding its scope.

At the root of the grabbing hand analysis are models of political behavior that argue that politicians do not maximize social welfare and instead pursue their own selfish objectives. Dictators use their powers to keep themselves in office, to direct resources to political supporters, to destroy political challengers, and to enrich themselves, often at the expense of public welfare. Democracies often imbue politicians with more public-spirited incentives, in part because they need to be reelected, but democratically elected politicians typically do not maximize social welfare either. As stressed by Buchanan and Tullock (1962) as well as by the authors of the *Federalist Papers* (1788), the winning majorities in democracies tend to pursue highly wasteful policies of redistribution from their losing minorities. Sometimes, for instance, the winning majorities impose extremely high—nearly confiscatory—taxes on the rich and transfer their wealth to themselves, even at the cost of stunting entrepreneurial activity and growth in a country. Sweden over the last thirty years is a good example (Lindbeck 1997).

Another reason why democratic politics give politicians objectives very different from social welfare is the influence of interest groups and lobbies on political choices (Olson 1965; Becker 1983). Lobbies influence political decisions because politicians need votes and contributions from their members. Lobbies use this influence to redistribute resources from the public to themselves, sometimes at a high social cost. Labor union lobbying for labor market restrictions and for massive social redistribution schemes under the Labour governments in Britain is probably an important reason for that country's stagnation prior to Thatcher's reforms.

The political models tell us that both despotic and democratic governments are likely to pursue goals that are very different from social welfare—the alleged objective of the helping hand government. The analysis here is therefore radically different from that of the helping hand model, in which the government maximizes social welfare. The analysis is also different from that of the invisible hand model, which does not have much of a theory of government at all. Because the grabbing hand model starts with politics, it can supply a descriptive theory of government choices and thus coherently analyze the pathologies—as well as the good uses—of the public sector. The analysis yields theories of government ownership and privatization, corruption, legal institutions, the growth of government, and so on. The grabbing hand analysis also serves as a useful guide to policy because it helps to formulate practical advice that recognizes the limitations of government. It can help design institutions that insulate economic agents from the political attempts to prey on them (something the helping hand model does not do) without assuming away the influence of government altogether (as is common in the invisible hand model).

This activism of the grabbing hand model raises a crucial question, namely, who is going to execute the reforms? After all, if the government is selfish, is it not a contradiction for its leaders to deliver political reform, particularly the kind of reform that makes the government weaker? The grabbing hand analysis surely does not presume that the reformers who improve social welfare necessarily have the sole objective of maximizing it. However, democratically elected leaders such as Margaret Thatcher in Britain, Carlos Salinas in Mexico, Boris Yeltsin in Russia, or Vaclav Klaus in the Czech Republic, among many others, often pursue policies of rolling back the state. They do so, at least in part, because their principal political supporters—both lobbies and voters—benefit from these policies. These benefits may include tax cuts, disinflation, improvement of opportunities for starting new businesses, increases in growth and productivity resulting from depoliticization, growth in financial markets, and so on. Indeed, the best opportunities for reforms favored by the grabbing hand model occur precisely when the political interests of the government coincide with social welfare. And one of the central, and most interesting, elements of the grabbing hand analysis is precisely how to build political coalitions in support of reforms.

As a preliminary illustration of the differences among the three views of government, return to the debacle of Crédit Lyonnais. What would be the three analyses of the bank's problems? A helping hand economist is unlikely to admit that Crédit Lyonnais's problem is one of political control. In fact, while this economist may recognize that the bank is in trouble and that the status quo is likely to lead to further losses and inefficiencies, he is likely to see the problem as one of corporate governance, that is, of market failure, rather than as one of political governance, that is, of government failure. For this reason, the helping hand economist would see a number of complexities and tradeoffs in the decision regarding what to do with the bank.[3]

To begin, the helping hand economist would see many advantages in state ownership of a large bank, including the possibility of subsidized loans to nationally and regionally important projects, the maintenance of large employment at the bank itself, the opportunity to use the bank to correct assorted failures in private capital markets, and so on. To pursue these social goals, political control is generally a plus. As a consequence, the helping hand economist is likely to resist a rapid privatization of Crédit Lyonnais, especially since the bank is so large that it might have market power.

At the same time, the helping hand economist might agree that corporate governance at Crédit Lyonnais has failed, and that therefore improvements in this area are in order. To this end, he might suggest offering the bank's management a performance-based incentive contract or appointing an independent board of directors. Of course, it would be better if these changes did not limit the control that the government needs to pursue its social goals. The helping hand economist might also suggest restructuring the bank's assets and maybe breaking it up, preferably under the supervision of a public commission. In the end, he is likely to support more government work with the bank rather than privatization.

Both the invisible hand and the grabbing hand economists would see many fewer benefits of state ownership. They would generally agree that the trouble with the bank is not corporate governance per se, but rather the fact that it is controlled by the government. As long as government control remains intact—either directly, through a government-appointed board, or indirectly, through a new commission—the bank's resources will continue to be wasted on poor projects at a large cost to the taxpayers. Corporate governance of Crédit Lyonnais may well be a problem, but it is a problem precisely because the ultimate control is political. As a consequence, both the invisible hand and the grabbing hand economist would recommend rapid privatization of Crédit Lyonnais. However, while the two economists would agree that private ownership of the bank is better, their views would differ in important details.

The invisible hand economist would generally be bored with the details of privatization. She would take the position that the less government intervention in the banking sector there is, the better, and that competition in the marketplace would take care of whatever problems the bank has. She might object to any government regulation of banking at all, including deposit insurance.

The grabbing hand economist would be more focused on the questions of why the bank is still publicly owned, and how privatization can isolate it from future government intervention in its activities. He might argue, for example, that to reduce the risk of future nationalization, the government should transfer to its own books some of the bank's bad loans. He might also argue that the shares of the bank should be sold as widely as possible, to make such renationalization politically costlier. If there is political opposition to privatization, say from the employees of the bank accustomed to having well-paid government jobs, the grabbing hand economist might consider ways of convincing these employees to go along, perhaps by bribing them with cheap equity. In this particular instance, then, while the invisible and the grabbing hand economists agree on the basic idea, the latter might get further in proposing a feasible strategy precisely because his analysis is much more focused on politics.

This discussion begins to make our case that the choice of the model is not just a matter of completeness, analytical elegance, or emphasis. Rather, we believe that both the helping hand and the invisible hand models often give incomplete or even incorrect answers to crucial economic questions, and that the grabbing hand model is much more likely to give the right answer. We establish this proposition more definitively in the rest of this chapter. In subsequent chapters we develop our grabbing hand analysis of particular problems, but do not specifically advocate it. Yet the principal benefit of the grabbing hand analysis is precisely this: it gives the right answers to problems of great importance.

1.2 Perspectives Matter

To begin, the grabbing hand perspective is helpful in understanding the existing institutions in different countries, the reasons for the ways in which they have been put together, and the benefits and costs of these institutions for economic development and growth. When writing about institutions in a country, such as ownership patterns, regulatory structures, and legal mechanisms, economists used to focus on the benefits of institutional development (e.g., North and Thomas 1973). More recently it has become clear that many institutions retard rather than accelerate growth (e.g., North 1990). Regulatory agencies prevent entry, courts resolve disputes arbitrarily and sometimes dishonestly, politicians use government property to benefit their supporters rather than the population at large. To understand how such dysfunctional institutions come about and stay around for decades or centuries, we need to understand the political objectives and powers of their designers and operators.

But an equally important reason for pursuing the study of the grabbing hand government is institutional reform. What strategies can reduce corruption in government bureaucracies? What reforms will prevent the state from using its companies to pursue political goals incompatible with economic efficiency? How should capital markets be regulated? What constitutes a good system of laws? Can foreign aid be useful? As already mentioned, the grabbing hand agenda is fundamentally activist, in contrast to the invisible hand's pessimism. The goal of this research is not to bash the government or to advocate pure laissez-faire. Rather, the goal is to understand how alternative institutions function under skeptical assumptions about the interests of the politicians, and to examine the strategies for replacing truly dysfunctional institutions with better ones, recognizing that reform itself must cope with political interests and constraints.

Our work on the grabbing hand government falls naturally into the public choice tradition initiated by Buchanan and Tullock (1962), Olson (1965), and Becker (1983). Our emphasis on institutional reform, however, is quite different from the skepticism of the public choice scholars. Buchanan, for example, is sufficiently skeptical about government in general and the tyranny of the majority in particular to oppose most policy reforms, and prefers once-and-for-all constitution building behind the veil of ignorance. Olson is similarly skeptical about government activism because he believes that policies are determined by lobbies, and lobbies promote inefficiency, leading to ever-increasing sclerosis of societies over time. Our view instead is that both popular majorities and lobbies can sometimes be used by political entrepreneurs to promote efficiency-improving reforms. Indeed, the grabbing hand perspective on government often suggests where a reformer can go looking for these helpful majorities and lobbies.

Many—though not all—of the essays in this book have been motivated by our advisory work in Russia on privatization, capital market development, and legal reform. This work convinced us that the perspective one takes on a problem matters enormously for the solutions that one accepts, advocates, or helps carry out. Starting with an inappropriate perspective, a beautiful theory, which yields the most logical set of policy prescriptions, will deliver an entirely wrong answer to the policy question at hand. To see this point—which is the most fundamental reason for this book—consider three examples of reforms that Russia and other emerging countries have faced.

Take first the example of privatization. Privatization is a striking example of how differently the three types of economists confront the dramatic performance failure of state firms. Helping hand economists are generally ambivalent about privatization, even when they accept as factual the pervasiveness of performance failures of state firms. In some cases, the helping hand analysis focuses on corporate governance and maintains that the problem with government-owned firms is poor selection and motivation of managers (e.g., Laffont 1994). Such analysis emphasizes the selection of the best management teams and proper corporate governance as the critical goals of reforming state firms. Privatization itself often becomes unnecessary if the government can find good managers and provide them with appropriate incentives. The helping hand analysis is also focused on market failure in the product as well as the capital market. Excessive monopoly power is then regarded as the fundamental problem of large state firms. The breakup and restructuring of these firms by the government, and the creation of new regulatory institutions, are needed before any privatization takes place (e.g., Tirole 1991). The beliefs in the centrality of management incentives and of monopoly follow naturally from the helping hand model of government and its emphasis on market, as opposed to government, failure. In this model, the government itself must guard against market failure, and therefore the analysis of privatization typically leads to extremely cautious, if not negative, recommendations. The consequence of this caution, as with Crédit Lyonnais, is the continued stagnation of firms under state ownership while deliberations about the tradeoffs go on.

The invisible hand perspective on privatization, particularly in emerging markets, is sometimes even less helpful. Recall that one of the few legitimate functions that invisible hand economists assign to government is the defense of property rights and the provision of law and order. Without these public goods, a market economy cannot function. In developed economies, where these institutions function well, invisible hand economists favor privatization, as the case of Crédit Lyonnais illustrates. But what if the market-supporting institutions are extremely undeveloped, as they are in many emerging markets? The recommendation of the invisible hand economists is to establish them. In fact, many invisible hand economists are adamant that the creation of institutions defending property rights should precede privatization, since without these institutions, the economic benefits of private property are likely to be small. For this reason, many free market economists opposed privatization in Russia in the early stages of reform.

The trouble with this invisible hand analysis of privatization is that it ignores politics. In particular, it ignores the fundamental fact that institutions supporting property rights are created not by the fiat of a public-spirited government but, rather, in response to political pressure on the government exerted by owners of private property. Privatization then offers an enormous political benefit for the creation of institutions supporting private property because it creates the very private owners who then begin lobbying the government. Without privatization, such private owners do not exist, and hence the political sentiment for creating institutions that support property rights is terribly weak. The Russian experience, in a striking way, confirmed the pitfalls of the invisible hand analysis. It is precisely because of privatization, and the creation of groups with a vested interest in protecting their own property, that the Russian government began to take steps to create market-supporting institutions. Without the political dimension to their analysis, the invisible hand economists missed a crucial dynamic of a transition economy.

The grabbing hand perspective on privatization is different from the other perspectives. Unlike the helping hand perspective, it suggests that the key problem of state firms is government interference in their activities to direct them to pursue political rather than economic goals, such as excess employment. As a consequence, the design of privatization must focus on restricting the possible future influence of the state on privatized firms, through subsidies, regulations, or even minority ownership. Indeed, assigning to the government the role of actively finding better managers or of restructuring monopolies contradicts the essential premise of the grabbing hand approach: that government control is itself the fundamental problem. The change in focus leads to a privatization strategy that aims at depoliticization rather than a mere reorientation of the allegedly benevolent government intervention in firms. The Russian privatization stressed such ideas as speedy and broad distribution of share ownership and cooptation of corporate insiders into supporting privatization. The program deemphasized corporate governance precisely because the intent was to reduce the damage from government failure rather than from market failure. The architects of the Russian privatization were aware of the dangers of poor enforcement of property rights. Yet because of the emphasis on politics, the reformers predicted that institutions would follow private property rather than the other way around.[4] Again, the difference in the economic model led to a very different approach to policy.

As a second example, consider the problem of fighting corruption by government officials. The helping hand diagnosis of corruption is that government bureaucracies select officials of poor quality (and morals) and that moreover the incentives facing these officials are not conducive to honesty. The officials have secure jobs, they are underpaid, and they are rarely penalized for corruption or rewarded for honesty. The helping hand model recommends a number of strategies for fighting corruption, including finding better people for government jobs and improving their incentives (e.g., Klitgaard 1988). Perhaps the bureaucrats should be paid more to reduce their temptation to take bribes, perhaps the penalties for corruption should be made heavier, perhaps there should be prizes and promotions for honesty. Most important, the helping hand model presumes that the government restrictions and regulations that create the opportunities to collect bribes are necessary in the first place. The reason for this assumption is obvious: since the helping hand economists see market failures everywhere, they also see much need for the government to restrict and regulate markets.

The invisible hand economist generally does not focus on corruption. To such an economist, corruption is one of many government failures, and not necessarily the worst one. Indeed, taking government regulations as given, an invisible hand economist sees many benefits of corruption, since it allows private agents to get around the regulations (Leff 1964).

The grabbing hand model, in contrast, begins with the idea that many regulations are introduced in order to enrich and empower politicians. As a consequence, the model immediately implies that deregulation and liberalization are far more important for fighting corruption than the improvement of incentives and personnel selection inside the bureaucracy. To the extent that some regulation is unavoidable, the grabbing hand approach suggests that individual bureaucrats must have as little discretion as possible in exercising their powers. We stress that this is a radically different approach to fighting corruption from that suggested by the helping hand economists. Indeed, the traditional helping hand studies of corruption are nearly unanimous in focusing on personnel policies inside bureaucracies rather than on what these bureaucracies actually do.

Our final, and perhaps most telling, example illustrates how the grabbing hand and invisible hand models sometimes offer radically different advice. The example focuses on the controversial question of foreign aid. Helping hand economists typically approve of most foreign aid. This is not surprising: since they see so many market failures in wealthy economies, they see even more in the developing ones (Stiglitz 1989). Since the government is supposedly curing market failures, and since foreign aid transfers resources to governments that have more market failures to cure, helping hand economists naturally support virtually all foreign aid. Useful aid covers macroeconomic assistance, health, education, industry, infrastructure, financial markets, the energy sector, and everything else that the World Bank supports.

The invisible hand economist, in contrast, is extremely hostile to all foreign aid (Bauer 1976). After all, it is a form of government spending, and one where the donor government might be especially ignorant of the effective ways to spend taxpayers' money.

In this particular instance, the grabbing hand view of foreign aid is sharply different from both of the others (Boycko, Shleifer, and Vishny 1995). The grabbing hand analysis would agree with the invisible hand view that most foreign aid is wasted, in part because the projects it supports are poorly selected and in part because the recipient governments