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# IRIS PROJECT

REPORT ON THE SECOND FISCAL QUARTER  
1 JANUARY - 31 MARCH 1993

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# IRIS

## Quarterly Report

(January - March, 1993)

April 1, 1993

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This report describes the activities of IRIS in the second quarter of Fiscal Year 1993 (January - March, 1993) as well as the activities that IRIS has programmed for the next quarter, April - June. The report concludes with a summary of how these activities represent progress towards the program goals for its second year that are described in the IRIS FY 1993 Annual Plan.

**IRIS Activities in the Second Quarter (for a review of activities in Chad, Mongolia, Nepal and Poland, see attached quarterly reports)**

1. Work in Particular Countries

a) *India*

On February 5, Dr. Isher Ahluwalia visited the IRIS Center and spoke on economic reforms in India at a luncheon seminar at the University of Maryland at College Park. Dr. Ahluwalia, who is currently a Research Professor at the Centre for Policy Research in New Delhi, has played a major role in framing the current debate on Indian industrial policy reforms. The seminar was sponsored by IRIS and the UMCP Office of International Affairs.

A number of articles on IRIS have been published in India. At the end of December (12/28/92), the *Economic Times*, a national newspaper, published an article about Mancur Olson and his work. In January of this year (1/31/93) the same newspaper carried an article featuring the proposed IRIS-India collaborative project. In February, the *Times* reviewed the IRIS Prague conference volume, *The Emergence of Market Economies in Eastern Europe*. Most recently, in mid-March the *Financial Express* carried a full page cover story on IRIS and the proposed IRIS-India project in all of its Sunday editions throughout India. Copies of the articles are attached.

*Future Activities:*

IRIS is planning a Worldnet tele-video conference in May among Washington, New Delhi, and Bombay on the topic of incentives and economic reforms in India. The goal of the Worldnet session is to involve leading Indian researchers in discussions of the research agenda that is at the heart of the proposed IRIS India project, and to communicate the importance of institutional incentives and the role of special interest groups in India.

IRIS will co-sponsor a conference on "Economic Liberalization in South Asia" at the University of California at Berkeley, California. Mancur Olson will give a talk about reform prospects and political constraints in South Asia, and Dr. Satu Kähkönen will make a presentation about the proposed IRIS India project.

Also in April, IRIS will co-sponsor with the UMCP Office of International Affairs a mini-conference on "Economic Reform in India, Bangladesh and Nepal" at the University of Maryland at College Park. Several IRIS staff will speak at this conference.

*Expected Impact:*

India is still at an early stage of economic liberalization. Acceleration is difficult both because of technical questions that must be answered, and because of almost inevitable political opposition. If concrete policy options, well-supported theoretically and empirically by sound economic analysis, are available before liberalization measures are proposed, these difficulties can be reduced. The IRIS collaborative research process, and the technical and strategic advice it can provide, are expected to provide valuable support for the preparation of studies that contribute to the process of liberalization.

**b) Madagascar**

The main activity of the IRIS Madagascar project during this quarter involved the final preparation and delivery of the IRIS Report on the *Environment For Investment in Madagascar: Institutional Reform For A Market Economy*. This report, authored by Hilton Root of the Hoover Institute, was the product of an assessment mission which he took to Madagascar in August of 1992 along with Roger Jantio of Sterling International, Professor Michael Krauss of George Mason Law School, and Professor Alain Lévassieur of Louisiana State University Law School. This project had two interrelated goals. The first was to examine the labyrinth of government bodies which foreign nationals and Malagaches must negotiate to make an investment in Madagascar. While there was some discussion of adapting a "guiche unique" in order to simplify the investment process, much work needed to be done in order to examine the efficacy of this proposal. The second goal of the project was to assess the legal environment for the investment process and to make recommendations for the reform of the judiciary and other legal institutions. The final English version of the IRIS

Report along with a draft French version were submitted in February to the USAID Mission in Madagascar. The French version was revised by the Mission and distributed in Madagascar after the close of the quarter.

The IRIS report made several observations and recommendations with respect to the legal environment, the investment process and governance reform. Madagascar's economic future depends on creating a legal environment that will encourage indigenous and foreign investment in the nation's vast economic potential. The government is currently unable to provide physical and institutional infrastructures that attracts investors. The under-reporting and export of profits, as well as the proliferation of informal markets for many goods and services deprive the government of the resources for necessary services. However, the efforts of economic actors to evade compliance with official controls reflect an economically irrational regulatory environment. This report discusses some of the questions which Madagascar must address before it can hope to attract investment. Some of these issues include whether the rules of the game are subject to rapid change or reversal; whether the procedures for changing the rules are arbitrary or whimsical; whether the rules of the game are clear and fair to all players. Other questions include the availability of information about economic opportunity and political decisions; the extent of bargaining between groups that hold economic privileges, and the accountability of regime officials. Finally the report considers whether regime officials are able to make commitments, what sanctions exist to ensure the government lives up to its obligations and what degree of independence the legal system enjoys from influence by the legislative and executive branches of government.

IRIS uncovered evidence suggesting that the present legal and regulatory environment offers potential investors inadequate protection from the risks of arbitrary seizure or capricious decision-making by bureaucrats. The legal system does not afford adequate remedies in the case of bankruptcy or non-contractual damages (torts). Similarly, property rights are not adequately specified or protected. The stability of long-term macroeconomic policy is uncertain. The judicial system is not adequately protected from political influence. Because the bureaucracy is not adequately insulated from executive authority, it cannot credibly protect investors from arbitrary rule enforcement. Indigenous investors do not have the same rights as outsiders. The rights of citizenship for key players in the domestic economic system are not assured. Recourse for the settlement of commercial disputes is lacking and as a result traders require secondary social sanctions before they are willing to engage in trade. Key figures in the political hierarchy possess market power that deters competition. The judicial system cannot provide protection from arbitrary behavior of government officials.

Solutions that can be immediately implemented as well as those that require time and significant training are proposed in this report. For example, a private system of dispute settlement is recommended. Traders who do not comply with decisions of arbitrators will acquire a reputation that will reduce their capacity to find future partners. The existence of a system of arbitration will allow reliable partners to distinguish themselves. A mechanism to establish reputations would increase

confidence and reduce some of the contractual problems that arise during economic expansion.

Training judges and lawyers in international commercial practices and law will take a long time, but must begin immediately. The report also recommends a simplified process for making investment decisions. Investments should not have to pass an elaborate screening process unless they are of a strategic nature. The ministry responsible for the screening should have sufficient powers to override other ministries should an impasse arise. A private agency that can offer investors reliable information about economic opportunities as well as the costs of doing business in Madagascar will be helpful. Mechanisms to coordinate economic decision-making between state and private sector representatives are also suggested in order to facilitate the dissemination of information about rules and their enforcement to all parties. The report also advises that conflicts of interest and the abuse of executive authority be constrained by a new constitution.

The report concludes that the level of investment needed to support growth will not occur until the legal and regulatory environment offers satisfactory solutions to each of these problems.

*Expected Impact:*

Private sector activity in Madagascar is obstructed by significant regulatory, legal and political deficiencies, ranging from excessive and excessively arbitrary regulation of business to an inadequate judicial system to a chaotic macroeconomic situation brought on in large part by the unrestrained use of government resources for the private purposes of some officials. The expert studies provide a clear indication of the extent of these phenomena incorporated in the IRIS Report, describe their devastating impact on economic activity, and offer directions for future reforms.

*Future Activities:*

IRIS hopes to have a team in place in Madagascar in August and September to work on issues of legal and financial reform and to prepare for a Round Table on these issues and the IRIS Report.

2. Dissemination of information to build awareness of the role of institutions in economic development:

- a. On November 18, IRIS provided assistance for the organization of a discussion on "Democracy: Should It Be the Goal of U.S. Foreign Aid?" Senator Richard Lugar was the featured speaker. Mancur Olson also made some remarks. Approximately 80 people attended this event at the Carnegie Center for Peace.
- b. On March 4, a WAFER was held with Yegor Gaidar, former Acting Prime Minister of Russia. He spoke on "Prospects For the Russian Economy: The

Next Three Months and Beyond." This event was held in the U.S. Capitol, and approximately 150 people attended. In his address Gaidar stressed the importance of targeted assistance to Russia. He said that to ensure that the reform process continues in Russia it is important to convince retiring military officers, managers of state-owned enterprises, and white collar women (the largest proportion of the unemployed) about its benefits. He also emphasized the need to train economists, lawyers, and accountants to carry out the essential reform of Russia's institutional arrangements. Gaidar met with senior government officials, members of the U.S. Congress and addressed a dinner sponsored by the Freedom Forum. During his visit plans were drawn for a joint proposal to support research related to the transition. That proposal will be submitted to USAID in the third quarter.

- c. IRIS Principal Investigator Mancur Olson made seven presentations in this quarter. At the meetings of the American Economic Association in Anaheim, 5 - 7 January, he presented "Political Upheavals: Collective Action and Inaction," and was a discussant of five other papers. On February 22, he shared the podium with Senator Richard Lugar in discussing the topic of "Democracy: Should It Be the Goal of US Foreign Aid?" On February 25, he gave a seminar at Williams College on "Dictatorship, Democracy and Development." On March 12, he spoke at the University of Montreal on "Repression, Rebellion, Dictatorship and Democracy." On March 13, he gave the Virginia School Lecture on Political Economy at George Mason University, on "Why is Economic Performance Even Worse After Communism is Abandoned?" On March 25, he testified before the United States Senate Finance Committee on the effects of the budget deficit. Finally, on March 26, he spoke at the Society for the Advancement of Socioeconomics on "From Interests to Morals: The Unity of Motivation Across Occupations and Roles."
- d. IRIS Director of Research Christopher Clague presented "PPP Puzzles: Food Prices, Agricultural Prices and the Cost of Living in America" at the meetings of the American Economic Association in Anaheim on January 10. He also presented a paper, "Strategies for the Transition to a Market Economy: Theory and Evidence," at the meetings of the Society for the Advancement of Socioeconomics in New York on March 27.
- e. IRIS Associate Director Philip Keefer and Research Associate Steven Knack (also with The American University) attended the Annual Meeting of the Public Choice Society March 19-21. They presented two papers that grew out of the IRIS Index Project: "Public Expenditures and Economic Performance: Do Institutions Make a Difference" and "Institutions, Increasing Returns and Economic Growth." Keefer also presented "Checks and Balances, Rent-seeking and Economic Development."
- f. Eight papers were added to the IRIS Working Paper Series:

Christopher Clague, "PPP Puzzles: Food Prices, Agricultural Prices and the Cost of Living in America," IRIS Working Paper No. 37, January 1993.

Mancur Olson, "Why Are Differences in Per Capita Incomes so Large and Persistent?" IRIS Working Paper No. 38, January 1993.

Karla Hoff and Andrew Lyon, "Optimal Sequencing of Land and Credit Market Reforms in Developing Countries: A Theoretical Perspective," IRIS Working Paper No. 39, January 1993.

Peter Murrell and Yijiang Wang, "When Privatization Should be Delayed: The Effect of Communist Legacies on Organizational and Institutional Reforms," IRIS Working Paper No. 41, February 1993.

Roger R. Betancourt, "The Economics of Retailing: Perspective and Prospective," IRIS Working Paper No. 42, July 1991.

Herschel I. Grossman, "Robin Hood and the Redistribution of Property Income," IRIS Working Paper No. 43, December 1992.

Herschel I. Grossman, "Production, Appropriation and Land Reform," IRIS Working Paper No. 44, November 1992.

Peter Murrell, "Reform's Rhetoric-Realization Relationship: The Experience of Mongolia," IRIS Working Paper No. 45, November 1992.

Two reprints were added:

Herschel I. Grossman, "Foreign Aid and Insurrection," *Defence Economics*. IRIS Reprint No. 16, April 1992.

Roger Betancourt and David Gautschi, "The Demand for Retail Products and the Household Production Model," *Journal of Economic Behavior and Organization*. IRIS Reprint No. 17, November 1989.

***Expected Impact:***

The WAFER series, the talks by IRIS staff and the dissemination of working papers and reprints on issues related to institutions and/or development create opportunities to present to a variety of audiences the importance of institutional concerns in many different contexts. The addition of papers by a renowned scholar such as Herschel Grossman, and by a widely recognized expert on the transition of centrally planned economies such as Peter Murrell, helps to ensure that the working paper series is viewed by development professionals as one of the most reliable and high quality sources of the latest developments in the analysis of institutions and economic development. In the pursuit of this goal, systematic efforts are underway to disseminate papers from this list to development professionals.

*Future Dissemination Activities:*

Aside from continuing talks to a variety of audiences, and a WAFER event involving a discussion by Japanese parliamentarians and others of the role of Japan in the world, particularly in the developing world, IRIS is working to bring the list of working papers and reprints to as broad an audience as possible.

3. IRIS Scholars and Fellows Programs

In February, ten IRIS Scholars and three IRIS Fellows were selected. Their topics follow:

## SCHOLARS

Shlomo Angel and Stephen Mayo (Urban Development Division, The World Bank): Measuring the Effect of the Regulatory and Institutional Environment on Housing Sector Performance: A Global Perspective.

Abhijit Banerjee (Department of Economics, Harvard University): A Simple Framework for Understanding Corruption.

Timothy J. Besley (Woodrow Wilson School, Princeton University): The Role of Informal Finance in Household Capital Accumulation: Evidence from Taiwan.

Jon Elster (University of Oslo): Constitution-Making in Eastern Europe.

Russell Hardin (University of Chicago): Liberalization and the Collapse of the Soviet Empire.

Joseph P. Kalt (John F. Kennedy School of Government, Harvard University) and Stephen Cornell (Department of Sociology, University of California, San Diego): Cultural Norms, Effective Self-government, and Economic Development on American Indian Reservations.

Yew-Kwang Ng (Monash University): The Transformation of the Ownership System in China: A Preliminary Study.

Julie Anderson Schaffner (Department of Economics, Stanford University): Employer Size, Wages and the Nature of Employment in Peru.

David Stark (Department of Sociology, Cornell University): Property Forms and Enterprise Governance in Hungary.

Mariano Tommasi and Cesar Martinelli (Department of Economics, University of California, Los Angeles): Optimal Sequencing of Economic Reforms under Political Restraints.

FELLOWS (University of Maryland)

Katharine Abraham (Department of Economics) and Milan Vodopivec (The World Bank): Dynamics During the Transition of a Socialist Economy.

Allan Drazen (Department of Economics). Explaining the Volatility of Capital Flows into Latin America.

Karla Hoff (Department of Economics). The Costs of Policy Intervention by a "Soft" State.

John Robinson (Department of Sociology). Survey of Entrepreneurial Activity in Russia.

4. IRIS Research

The IRIS Index: Papers from the Index were presented at the Public Choice Meetings in New Orleans in March. Work on the this project continues to generate relationships between democracy and growth, and several intermediate variables.

*Expected Impact*

Research into the determinants of growth is growing by leaps and bounds, both in quantity and prestige. Conclusions from this literature, such as the importance of equipment investment for economic growth, have captured the attention of high-ranking policy makers. The role of political and legal institutions in the growth process remains in the background, however. Among the contributions of the IRIS Index Project will be to introduce institutional variables systematically into this literature.

**Progress towards Achievement of Third Year Objectives Established in IRIS FY 1993/94 Annual Plan**

1. **The Democracy Initiative: Participation as an Economic Development Strategy:** The methodology IRIS has employed in project implementation, most recently through the Company Law Workshop in Nepal, has been to solicit input from all interested parties in the preparation and advocacy of reforms. IRIS attempts to establish by example the efficacy and benefits of transparent decision making that allows for ample feedback from all affected segments of society. Moreover, in Chad and Madagascar, IRIS is exploring reform options that directly touch upon democracy issues, including the independence of the judiciary.
2. **Implementation of field projects:** IRIS has engaged in extensive recruitment efforts for the Long-Term Advisor position in Chad, which are expected to conclude in May. In Nepal, IRIS has seen the breadth of its activities increase

substantially, and in June expects to bring foreign experts to Nepal to advise the Nepalese about contract law, securities regulation and offshore banking.

3. Development of additional field projects: As indicated above, substantial efforts continue to be made by IRIS to develop a program to build up the capacity of Indian researchers to conduct research on policy and institutional reform. IRIS continues to work on developing a buy-in in Madagascar.

Finally, discussions have been underway in Mongolia, Poland and Nepal for extensions of existing buy-ins to continue the activities that IRIS has begun in those countries. Collaboration is ongoing with Robert Klitgaard to develop a large-scale investigation of the potential of spontaneous institutions for generating economic growth. These efforts are in addition to those expended to initiate institutional reform activities in the Newly Independent States.

4. The development policy community continues to be a target of IRIS efforts to increase awareness and understanding of the importance of institutional issues for economic development. This community has been well-represented at the WAFER sessions involving Senator Lugar and Yegor Gaidar. In addition, IRIS publication activity shows marked expansion.

#### **Major Activities Anticipated for the Period April - June, 1993**

WAFER with Japanese parliamentarians;

WorldNet with India and conclusion of buy-in negotiations;

Expansion of activities in Nepal, including the hiring of several foreign experts;

Extension of Mongolia, Nepal and Poland buy-ins;

Continuing elaboration of the IRIS Index.

**Attachments:** Quarterly Reports for Chad, Nepal, Mongolia and Poland  
Eight working papers and two reprints.

# SUNDAY

FINANCIAL EXPRESS

AY March 14, 1993



# IRIS

## AN EYE FOR TOMORROW

Transition to a market-led system does not end with the scrapping of state-controlled economics. It starts with it. As countries across the world attempt to navigate the twists and turns of change towards an open economic order, there is a need for a multi-disciplinary approach to reform.

We in other words probably need IRIS, says Srivatsa Krishna.

**L**minate. Only in retrospect does it appear otherwise. Indeed, at first sight, the rise and decline of nations across the canvas of time presents a seemingly baffling conundrum. What then are the unique factors that set apart the winners from the losers among nations? Further, what is the reason for some nations faring spectacularly at one time and doing badly at other times? What indeed are the reasons for the current rush of nations worldwide towards democracy and markets? And finally, is most of human civilization on the correct growth path that will ultimately get the best out of each individual and indeed reward him as well?

Economists, political scientists, sociologists and anthropologists from across the ideological spectrum have been providing numerous answers to these and other questions. But it is difficult indeed to find a solution that combines the insights of all the above and is yet refreshingly different. Indeed, Prof. Mancur Olson, Chairman and Principal Investigator of the IRIS (Institutional Reform and the Informal Sector) does so with admirable finesse. Not only does he dare to traverse unexplored territory of institutional economics but more importantly he says things that few have said before. His pathbreaking theories and analyses are bound to serve as a guide for all economies in distress as they meander their way through the painful and uncharted path of transition to democracy and markets.

The essential distinction between alternative economic systems is the extent to which governments replace markets or markets replace governments. The ongoing drive towards the market world-over, indicates more of the latter at the expense of the former. As in everywhere else, here too there is no one single ideal system available and invariably one has to strike a balance between the desirable and the not-so-desirable elements in each.

Policy-makers across the globe, are continually engaged in this onerous occupation, by trying to create a set of incentives and institutions that seek to garner the best out of each individual in society, in order to achieve the larger objectives of development.

The last decade saw some nations scaling new peaks of achievement while others

retrogressed in economic performance were not merely due to the varying amounts of capital, technological superiority, human or other resources available to different countries.

Recent economic history shows that neither the propensity to save nor the abundance of resources set apart the success stories from those who failed. Indeed, almost always, the former have been distinguished because of the superior quality (and not quantity) of their organisations and institutions. While recognising the importance of other factors also, the IRIS project preaches that development depends chiefly on institutions.

### INSTITUTIONAL IMPEDIMENTS

**Institutions offering poor structures of incentives, are at the root of floundering Third World economies**

The above constitutes the broad framework within which the forthcoming IRIS project seeks to operate. There are two main purposes of the IRIS project: First, it endeavours to enlarge knowledge about the role of institutions through research and secondly, it seeks to promote institutional reform in the third world and in countries undergoing transition from communism by providing technical and organisational assistance.

History has shown that the mere dismantling of a communist system does not lead to an automatic switch over to a market mechanism. It requires institutions that most people in the economically developed world take for granted, but that the emerging economies of Eastern Europe, Asia, Africa and Latin America usually do not have. Further, most of these societies are characterised by different degrees of social, economic, technological and political schizophrenia. As such, the challenges that a reform economist faces are myriad and complex.

The main institutions of concern to the IRIS are the rules that structure incentives to stimulate production and mutually advantageous trade, and that provide the legal framework for democratic societies with competitive markets. The central premise of the project is that institutions in the unsuccessful economies of the Second and Third Worlds offer poor structures of incentives

activity into the informal economy."

The IRIS project contends that a market economy requires, among other things, institutions that provide secure individual rights, to ensure that individuals and the firms they create, best advance their interests by being as productive as possible and by engaging in mutually beneficial trade. Similarly, a society cannot have much borrowing and lending or obtain many of the other gains from mutually advantageous trade unless individuals and firms have the right to make contracts with one another that will be impartially enforced.

Thus for a private economy to thrive one needs risk-taking, innovations and a contracts system and these in turn require a stable and impartial legal and judicial system. It is only in stable developed democracies that there is a widespread confidence about the long term sustainability of such rights. Thus, indeed it is no accident that the countries in the world with the highest per capita incomes are stable democracies.

There is a strange dualism in governments that partly explains why the institutions needed for successful development are not more generally understood or more widely used. In the absence of government, a powerful individual may physically possess something, but no one has any socially enforceable rights, that is there is no private property without government.

On the other hand, just as governments are essential for individual rights, if they choose to unilaterally suspend or appropriate them. Herein lies a powerful paradox—that sustained economic development may require governments that are strong enough to last indefinitely, yet so limited and restrained that they do not use their overwhelming power to abrogate individual rights.

These presumptions, in a nutshell, are some of the reasons as to why institutional reform is a fresh and promising approach to economic development. With this approach the IRIS project will not only stimulate innovative and socially useful research, but will also provide a new kind of assistance to receptive organisations and individuals in the developing countries.

This research and assistance will help interested countries develop the institutions needed to generate the prosperity and



**"In any kind of an economic system, the role of institutions is important. So are other factors. With someone as erudite as Prof Mancur Olson at the helm of the IRIS project, it is in safe hands."**

**KAUSHK BASU**  
Professor of Economics, DSE



**"Policy-makers in India, pay lip-service to please labour and farmers, but covertly favour industry, which is the most productive sector. Institutions in developing countries are rendered ineffective by coalitions."**

**MOHAN NARAYANAN**  
DGM and EA to MD, Escorts Ltd.

The IRIS Centre has produced a paper titled 'Cooperation, Conflict, and Economic Development in India' in which it seeks to find out as to why India adopted the policies it did, over the last forty-five years. The paper argues, "economists provide a menu of policies which suit varying tastes; which policies are picked depends on other social/political considerations. Following this line of reasoning it is not sufficient to argue that the wrong policies were adopted; we need to explain why they were adopted and why they stayed in place despite the fact that there were so many warnings and criticisms. An analysis of the role of interest groups and lobbies is of obvious relevance here."

The other disease that plagues India at almost all levels is a sad and conspicuous absence of proper implementation of the innumerable government programmes that are ritualistically announced. The reason for this can once again be traced back to the interplay of interest groups in Indian society.

Prof. Mancur Olson's work, regarded a classic in mainstream political economy, provides answers to the above conundrum. His much acclaimed works are: *The Logic of Collective Action* and *The Rise and Decline of Nations*. In these works, he attempts to portray and predict the behaviour of various interest groups and coalitions within a society and as to how they influence or capture the course of policies that a nation ultimately chooses to follow.

#### THE CONCEPTUAL CRADLE

**A nation's development course is determined by the power wielded by its dominant coalitions or interest and their interplay**

The core of his thesis is that in every society there exist numerous interest groups, cliques and lobbies. Quite often there is no single group that dominates society as a whole, but in fact there exist a few large and many small lobbies which are fighting for political and economic space. Over time almost all stable societies, accumulate many such interest groups and lobbies who make policy-making by the government both, slow and contentious. Olson's logic contends that due to the

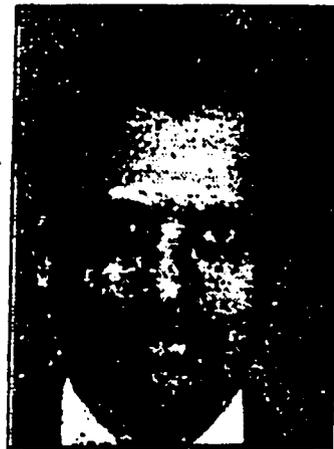
group to ride free (rather than bear a part of any of the costs incurred by the group to bring about any positive change), most of such groups do not take pains to bring about any change in the economic incentives or to increase the size of the overall societal pie. Instead, all such lobbies and groups are content with engaging in distributional struggles for a larger slice of the existing economic pie.

As such, most societies be it the older developed democracies like Britain or the newer faction-riddled ones like India (that readily lend themselves to the formation of such distributional coalitions) are trapped in the tweezer-like grip of stunted economic growth. Economic policy is a part of the bargain that is struck between these groups. It is perhaps the main instrument by which the spoils are distributed among them.

His work evinced a particularly significant interest during the recent US elections when the concept of a Grid-Locked government (A government held in grip by various interest groups) gained currency. Olson believes that social science would gain much if it is viewed and analysed in a holistic and integrated manner for many of the contemporary issues therein cannot be strictly circumscribed by the academic boundaries of separate disciplines. A unified approach is thus in order and Olson terms this as Encompassing Economics. Indeed, if nourished adequately this should go a long way in not only greater conceptual clarity about the issues at stake, but would indeed, due to increased cross-fertilization enrich the various disciplines themselves.

The IRIS Centre is involved in three broad kinds of activities: *First*, providing assistance to reformers by way of advice, technical know-how, legal assistance and in development strategy formulation. *Secondly*, it is engaged in research on broad institutional and policy issues and *Thirdly*, it seeks to disseminate information to improve the understanding of institutions to growth and reform through meetings, publications and individual consultations. Already IRIS experts have done commendable work in these areas in Nepal, Poland, Chad and Mongolia.

Mounted on a blockbuster format, IRIS hopes to involve a number of individuals



**"The oligopolistic power of interest groups is best seen in public expenditure policies and we propose to analyse the role of coalitions in determining public expenditure policies at the State level."**

DR M GOVINDA RAO  
NPPF

and institutions from the field of economics and political science from within India to chart out policy alternatives that will assist the ongoing process of economic liberalization. The IRIS Center is located at the University of Maryland at College Park and its worldwide projects receive financial support from the United States Agency for International Development (US AID). Final approval from the Government of India is necessary before the commencement of any venture.

Any organisation or educational institution which desires to participate in the project has to submit a research proposal which is then scrutinized by IRIS experts. The proposal is approved on a purely competitive basis vis a vis other similar projects that are received by the IRIS Centre. It needs to be highlighted that the concerned institution is free to choose its own research objectives and IRIS will lend its technical expertise and financial support in the hitherto unexplored field of institutional economics. The IRIS staff consists of economists and lawyers who have

first hand experience in institutional reform.

The institutions involved are in no way concerned to accept IRIS' logic and they are free to come to their own inferences also. To paraphrase the IRIS Research Programme Outline Paper, "The research supported by the IRIS project is not restricted to any one methodology or disciplinary perspective. If it promises sound results of practical significance, IRIS will, for example, support research of any level of technical complexity and also historical research on situations in prior centuries that generate insights of pertinence to institutional reform today." Indeed, this is a stellar factor for it does away with any kind of ideological tilt to the project. Such projects would go a long way in providing fresh insights and perspectives which would unarguably bolster India's economic liberalisation programme.

The IRIS Center has received proposals from the Jawaharlal Nehru University, National Institute of Public Finance and Policy and the National Council for Applied for Applied Economic Research, among others. The NIPFP proposal seeks to study government expenditure at the State level to gain a better understanding of the role of special interest groups in

determining State expenditure policies in India. For this purpose, they intend to analyse changes in agriculture. It looks at the comparative advantage of various regions of the country and the role of the various marketing institutions in a liberalized framework of agriculture.

In sum, as the caravan of reform gathers momentum across the globe, the issues raised by the IRIS project promises to contain enduring lessons for all. Time and time again economics has tried to free itself from the abiding tyranny of the cocooned sterile models which often have little relevance to mundane human existence. The IRIS project may eventually ensure that the very fabric of social science acquires exciting new patterns, through the threads

used therein need not be fundamentally a new.

The foremost task of economics and politics is to intersect as non-invidiously as possible and the folklore of reform across the world, in essence, seeks to achieve such a harmonious construction. The raison d'etre of all reform economics and indeed the IRIS, can be found here. ■

This essay collection is an instructional manual for policy makers, says Srivatsa Krishna

# Designer denouements for East Europe

The Economic Times  
of 04/21/93

**The Emergence of Market Economies in Eastern Europe** ed. by Christopher Clague and Gordon C. Rauster.  
Basil Blackwell, 352 pages, price not stated

**R**EFORM has suddenly come to occupy a status of legitimacy, desirability and respect. Indeed the story of the '80s and beyond is evidently going to be the story of reform — economic, social and political. Thus all of a sudden economics has sprouted many new and hitherto hidden branches such as reform economics, transition economics, transition economics, evolutionary economics and what have you.

A necessary accompaniment of this slightly-belated flowering of the discipline are the numerous voices, each claiming to be God's own apostle on the subject, competing for intellectual space. Against this backdrop, the book represents the way ahead, as shown by some of the important pundits of the world today.

What makes this book special is the terrain that it has covered. Apart from throwing fresh light on oft-debated issues like privatisation, safety nets and macroeconomic stabilisation, it also examines a whole array of human, social, institutional and political choices. The unusually stimulating flavour of the book can well be traced to this treatment.

The most brilliant essay is by Mancur Olson, chairperson of the Center for Institutional Reform and Information Sector (IRIS), University of Maryland, who delineated the hidden path to a successful economy.

Explaining the reason for dwindling rates of growth during transition times, Olson argues that either Soviet Union had the benefit of a single owner in Stalin. It was in Stalin's interest to ensure that the USSR functioned well for he had an encompassing and not a sectional or narrow-interest vested in it.

Through the parable of the disreputable manager, Olson enumerates the second reason as to why Soviet-type economics performed as well as they did, which was not because of the absence of the market as pop-

ular contemporary mythology would suggest, but in fact because of the existence of many markets, legal and illegal, implicit and explicit.

He makes another striking observation when he argues for the establishment of secure individual rights and enduring democratic institutions through the logic of economics. Olson observes that the desire to realise gains from trade,

University and chief economist of the World Bank, broadly classifies the reform process into four broad categories: macroeconomic stabilisation, price and market reform, enterprise reform, and restructuring and institutional reform. He also sketches out a sequence and speed chart for economic reform in Eastern Europe.

Summers argues that apart from the standard financial and technical assistance, Western nations would do well to lower barriers and allow access for East Europe's exports. The alternative to this is that the European Commun-

well to learn from the mistakes of the West and adopt a custom-made hybrid system for itself. Stiglitz espouses the Japanese model as being a good example to follow wherein a consortium of a bank and numerous firms coexist and compete with other similar groups. The essay also enunciates that for commercial banks reputation is an asset worth preserving, provided there is economic reform. Indian banks, alas, have rid themselves of both these onerous burdens — reputation and returns — years ago.

Indeed, financial sector efficiency invariably runs off on the real

uncertainty that reforms will take hold, the weaker will be the response to whoever has taken place. The weaker that response, the more political opposition there is likely to be to the reform. That opposition, in turn, will further increase uncertainty as well as the difficulty of achieving agreement on reform," says Krueger about the vicious side of it. This statement contains in it the rationale for speeding up the reform process and indeed holds much water for most of the developing world.

Jan Winicki, president, Atlantic South Research Center, Warsaw, refutes the existence of any third way by saying that there is no capitalism without capitalists. Reflecting on the various privatisation experiences, he points to the three common mistakes committed by most — concentrating upon the means or methods of privatisation before considering its goals; neglecting the time factor; and disregarding the politics of privatisation. The last is of particular importance owing to the presence of numerous vested interests everywhere.

Winicki forgets to mention that privatisation has seldom succeeded without an accompanying programme of education. Further, he does not touch upon a crucial component, namely, the source of funds for buying assets. The last point is of paramount importance to economics with thriving parallel markets.

There is a perceptive introduction by Christopher Clague of IRIS who captures the journey to a market economy in a nutshell. This book is a repository of the collected wisdom of some of the world's finest reform economists and is indeed an instructional manual for policy-makers. It offers some 'designer denouements' for Eastern Europe which have applicability to much of the developing world as well. Indeed, as the adage goes: if the night seems at its darkest, then dawn cannot be far away.

The solutions proffered herein could well contain rays of the long-awaited dawn for all those countries surrounded currently by an all-enveloping politico-economic trauma.



The ugly face of nationalism. The fires are fed by immigration from the east

Schumpeterian dynamism and the general incentive to maximise the output of assets are unleashed in a stable and predictable political environment wherein impartial institutions protect rights and arbitrate disputes.

Olson concludes: "It is no accident that the most prosperous societies are also those with the institutions that provide the greatest individual rights". Indeed, a journey through the masterly Olsonian analysis contains valuable lessons for policy-makers across the globe.

Lawrence Summers, Harvard

ty would soon be confronted with a sensitive immigration problem. Thus, if not for altruistic reasons there is at least one domestic compulsion that just might force the West to lower trade barriers.

"If capital is at the heart of capitalism, then well-functioning capital markets are at the heart of a well-functioning, capitalist economy" — thus argues Joseph E. Stiglitz, Stanford University. In an essay on the contours of future financial systems, he argues that while there are no ready-made solutions, Eastern Europe would do

sector and its virility and efficiency hinges greatly on the ability of the economy to raise and allocate capital. Stiglitz's arguments have a wide applicability for Indians as well, as it struggles to reform a dying financial sector.

Anne O. Krueger, Duke University, says that most reform experiments have shown that the role of the government has moved from an instigating and initiating one to a supportive one. Krueger delineates a circle that can be either vicious or virtuous. "The longer people are uncertain and the longer there is

# IRIS offers a new vision for economies in transition

AS COMMUNIST regimes fell one after the other and almost all countries in the world took the road to capitalism, economies undergoing transition groped in the dark.

And as a perfect capitalist system is as impossible as a perfect socialist system, the need to strike a balance between the two

while policy makers all over the world are trying to create a set of incentives and institutions that get the best out of each individual in the society to achieve the larger objectives of development, IRIS (Institutional Reform and the Informal Sector), an American project to help Third World countries in institutional reform stands out.

The project which functions under the University of Maryland hopes to involve individuals and institutions from the fields of economics and political science in India. At a time when Indian reform experiment has lost some of its early pace, the IRIS project could inject the tonic needed for its invigoration.

IRIS attempts at providing technical and organisational assistance to the Third World and the countries undergoing transition. Its prime area of concern is the poor structure of incentives in these countries.

Prof Mancur Wilson, the principal investigator of the project, has done pioneering works in this field.

His books include *The Logic of Collective Action* and *The Rise and Decline of Nations*. He tries to portray and predict the behaviour of the interest groups and coalitions within a society and how they influence or capture the course of policies a nation chooses to follow.

His works evinced interest during the recent presidential elections in the US, when the concept of a grid-locked government—a government controlled by various interest groups—gained currency. He believes social sciences shouldn't be confined to academic disciplines, and is for a unified approach transcending the academic frontiers and reaching the realm of practice which he calls 'encompassing economics'.

Economists Pranab Bardhan and Ashok Guha have introduced some of these thoughts to Indian political economy.

IRIS emphasises on institutions. The contrasting economic performances among countries is attributed to the quality of their organisations and institutions. IRIS believes that development depends mainly on institutions that provide individual rights.

Risk-taking, innovation and a contract system are necessary for a political economy. These, in turn, require a stable and impartial legal and judicial system. It is no accident therefore that countries with the highest per capita income are stable democracies.

Although governments are essential for protecting individual rights, they sometimes choose to unilaterally suspend or appropriate them.

It is a paradox that sustained economic development may require governments that are strong enough to last indefinitely, yet so limited and restrained that they do not use their overwhelming power to abrogate individual rights.

As more and more countries jump onto the reform bandwagon, the issues raised by the IRIS project are too grave to be ignored. More so in the case of a staggering economy like India's.

■ Srivatsa Krishna

**D**OWN the ages, economists of all hues have attempted to analyse Man's behaviour. History has, however, repeatedly consigned most of their predictions to the dustbin.

Nonetheless, there have been a few exceptions who have achieved amazingly consistent results, even when dealing with something as inconsistent and non-quantifiable as human behaviour.

Among these, Professor Mancur Olson, of the University of Maryland, USA, has been distinguished for two of his works—*The Logic of Collective Action* and *The Rise and Decline of Nations*. Dr Olson was recently in New Delhi in connection with a project on India's political economy of development that he is initiating under his programme on Institutional Reform and the Informal Sector (IRIS), in collaboration with USAID and leading Indian economists.

The IRIS project intends to prove that what works everywhere else can work in India also. It seeks to show that any nation's success or failure in the economic arena is due to the quality of her policies and institutions and not because of any other esoteric or mystic reason.

Though Dr Olson admits that he is not really an India specialist yet, he does say: "Water flows downhill everywhere and as such there is no Hindu rate of growth for India."

The choice of India for this project, according to Dr Olson, is not only because of the fact that she is an important Third World country, but also because she is "prototypical" for his work.

The single underlying motif of all his themes can be traced back to the behaviour of distributional coalitions and the logic of collective action. According to this logic, any large group or organization, if composed of rational individuals, will not act in their group interest.

This simple yet powerful paradox about the behaviour of groups can be traced to the free rider problem, wherein the costs incurred for bringing about any change are borne by a single individual, while the benefits invariably accrue to all, irrespective of whether or not the individual contributed or not.

This is so because any good that is collective in nature bestows its benefits on all, while the contribution of any one individual in acquiring is bound to make little difference to the amount provided, thereby arousing the incentive to ride free.

The above logic is further extended to explain the behaviour of various cartels, interest-groups and lobbies in any society. Argues Dr Olson, "Such organisations for collective action within a society will thus have little incentive to make any significant sacrifices in the interests of society and instead they seek to serve the interests of their

PROFILE / Mancur Olsen

# Redrawing margins

The importance of Dr Olson's work lies in his use of a mix of sociology and economics to explain human behaviour.

constituents by trying to seize a larger share of the societal pie."

In other words, such special interest groups seek to capture and distribute a larger slice of the pie rather than increase the size of the pie itself, thereby ensuring a noisy and divisive polity. Further, such distributional coalitions slow down a society's capacity to adopt new technological changes, and reallocate resources in response to changing conditions, thus putting a fetter on economic growth.

**A**PART from this, Dr Olson is working on a number of other models to explain the linkages between diverse types of political systems—democracy and autocracy—and their impact on economic and human development. Using the above logic he explains the existence of phenomena as diverse as law and order, optimal taxation systems, race and caste system,

hope to explain the diverse rubric of human life?" With such a wide ambit to start with, the titles of his other major works are indeed apt and ambitious: *An Encompassing Economics*, and a forthcoming book: *Beyond the Measuring Rod of Money: A Unified Approach to Economics and Other Social Sciences*.

It is argued here that there has to be a measuring rod beyond money to measure the efficiency and output of governments. With this, he seeks to explain what he calls the '4-S Syndrome' in governments, namely, short-sighted, schooled people, seniority and sycophancy. Further, Dr Olson is in the process of putting together his various models on the types of political systems and the quality of economic development in a book tentatively titled *Dictatorship, Democracy and Development*. He is also working on the economic transition in Eastern Europe wherein he investigates why economic performance is worst after the collapse of communism.

There have been two major criticisms of Dr Olson's works. First, he has been accused of being too 'spongy', that his various models have been often directly contradictory to each other. Secondly, economists like Dr Gerald Maywell and Dr Charles Kindleberger have assailed him about his excessive preoccupation with the free-rider problem.

While accepting some of them with respect, Dr Olson concedes that though he has not been able to reconcile some of his diverse models and results together, nowhere has he adopted convenient assumptions in order to arrive at the result that he was looking for.

Time and time again, economics has tried to free itself from the debilitating tyranny of cocooned sterile models which have often little resemblance to everyday mundane human existence. As Dr Olson says, mainstream economics, as against encompassing economics, suffers more from sins of omission than from sins of commission.

The significance of Dr Mancur Olson's work lies in his pioneering attempt to redraw the constantly shifting margins of economics and sociology by attempting a non-leviathan intersection of the two. Indeed, the larger relevance of this deceptively simple occupation can only be understood by taking an encompassing view of social science of human life itself.

**O**rganisations for collective action seek to serve their own interests by trying to seize a larger share of the societal pie.

gender and bureaucracy.

"The first blessing of the invading hand is that it transformed the roving bandit into a stationary one. History until relatively recent times has been, in large part, a story of the gradual progress of civilization under stationary bandits interrupted by occasional episodes of roving banditry. Much of human progress from the time of Sargon of Akkad to Louis XVI and Voltaire, is due to this blessing—to the superior incentives to produce and create under rational self-interested taxation than under anarchy," argues Dr Olson. The basic philosophy that is outlined in almost all his works is that both economics and sociology must constantly keep re-defining each other's boundaries, quite simply because they circumscribe all aspects of human life. As he puts it, "Can one theory ever

■ Srivatsa Krishna