EXECUTIVE SUMMARY

ADJUSTING TO REALITY

BEYOND "STATE VERSUS MARKET" IN ECONOMIC DEVELOPMENT

Robert Klitgaard

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

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An International Center for Economic Growth Publication

ICS PRESS
San Francisco, California

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This is an executive summary of the book *Adjusting to Reality: Beyond "State versus Market" in Economic Development*, by Robert Klitgaard, published by ICS Press in 1991 and distributed to the trade by National Book Network, Lanham, Maryland.

Cover design by Herman & Company.

ISBN 1-55815-186-9

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Preface

The true test of civilization, Boswell once said, is a decent provision for the poor. By that measure, economic analysis has been spearheading the civilizing process for some time, and it takes an exciting new turn in this volume by Robert Klitgaard. Poverty, Klitgaard argues, is—and should be—a principal concern of development strategists, but policy makers and analysts will continue to run from pillar to post in their search for a cure unless they can adjust their development schemes to reality.

Since the early 1950s, those schemes have been guided by two vastly different ideas about the role of the state in economic development. For a time, public planning and investment were extolled in many parts of the world, especially in former colonies that were eager to overcome the inequalities, exploitation, and elitism they had experienced under foreign powers and private enterprise. By the 1980s, however, disillusion had set in because the interventionist state had not promoted growth as expected. Instead, elitism and corruption had again become rampant as industries hid behind the state's protectionist policies and some countries succumbed to dictatorships.

Then came a move toward freer markets and greater emphasis on the private sector to ignite economic growth. As a result, the role of government has been shrinking in recent years. But the free markets are not magically solving the problems of the poor and underdevelopment. Free markets have weak institutional foundations in developing countries and thus tend to malfunction or do not even exist. Peasants and the poor have not immediately benefited from the numerous economic reforms undertaken in the past decade. In Klitgaard's view, the debate over markets versus government intervention fails to get to the heart of the matter. It is not enough to declare markets free or to rely exclusively on government efforts. A new strategy is needed—one that recognizes the strengths and weaknesses of each. The challenge, he says is to make both the market and the state work better.

But they cannot be made to work better as long as economic theory, empirical research, and politicians pursue simple answers such as "government intervention is bad (or good)." The time has come, Klitgaard advises, to admit that both the market and the state have functioned badly in most developing countries—not because there is anything inherently wrong with the theory of the free market or of the efficient, benevolent state. The problem is that these theories ignore the reality of the conditions in developing countries.

How, Klitgaard asks, can the government work efficiently in conditions of adverse incentives, corruption, and overcentralization, and how can markets work well when there is no tradition of enforcing contracts and property rights? And how can poverty be eradicated when markets, the government, the press, and the legal system overlook or misunderstand the ethnic dimensions of poverty in the world? We must, Klitgaard urges, adjust to these realities.

The new approach to policy analysis that the author proposes is based on two fundamental principles. One is that the proper choice of economic strategies cannot be determined in the abstract but depends on particular circumstances, which differ not only from one country to another, but also from one time period to another. In other words, the real environment must guide our policy decisions. The other is that information is at the heart of the problems in the real world of the developing countries. Market institutions cannot work without information about prices, quantities, and quality; and government institutions cannot work without information about outputs and outcomes.

Klitgaard offers examples from Bolivia, Brazil, India, Indonesia, Malaysia, Pakistan, Peru, and the Philippines to make his point—a defining characteristic of underdevelopment is that markets have poor information about the quality of goods, services, risks, and people. But instead of proposing formal models to resolve these problems, the author suggests creative ways in which the state and citizens themselves can solve their own "inevitably unique problems." One of the key tasks, in Klitgaard's view, is to ensure that environments are rich in information.

This volume offers a broad framework for policy analysis that moves us closer to intelligent solutions to the real problems of the real poor in the modern world. The literature on economic development will benefit greatly from this illuminating discussion of the interrelationships between public policy and environmental analysis.

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General Director
International Center for Economic Growth

August 1991
Panama City, Panama

Author's Preface

It was early November of 1988. I had just departed the tiny and impoverished country of Equatorial Guinea, where I had been working with the government for almost two and a half years on an economic rehabilitation program. Three days later, I found myself in La Paz, Bolivia. The transition from the tropics to the world's tallest capital city was breathtaking. So were the country's problems.

I had worked in Bolivia for two months in 1985. That was the time of its remarkable structural adjustment program, a combination of inflation-fighting and free-market reforms that shocked the country and the world. Here was a nation whose revolution of 1952 had been watched and admired by many who favored state-led growth, nationalization, and land reform. But in August 1985, with inflation racing along at 20,000 percent, the newly elected government of President Victor Paz Estenssoro carried out a remarkable about-face. The same President Paz who had been the leader of the 1952 revolution now launched a new one, this time toward a free-market strategy of economic development.

But by 1988 the economy had not responded. Although inflation was under control, per capita production and consumption continued to fall. Private investment had not picked up. It was said that most of the poor were worse off than before Bolivia's New Economic Policy. As I write in early 1991, five and a half years after the reforms, roughly the same conclusions hold.

In this syndrome Bolivia is not alone. In many of the fifty or so countries that have been part of the unprecedented worldwide move toward free-market strategies of economic development, the results so far have been disappointing. Markets turn out not to function as well as the textbooks advertise. Cutbacks in public spending lead to increased poverty, particularly among disadvantaged groups. I found it striking in countries as different as Equatorial Guinea and Bolivia to hear people describe similar problems.

"Free markets have been declared, but they haven't yet reached the poor." Markets for products, credit, and labor need to be democratized. If they are not, only the rich and the foreigners will benefit from structural adjustment. Part of the solution is getting government off the back of the small producer and business person. But only part. Many of the markets the poor in developing countries face are highly imperfect. What proactive roles should public policy play to make markets work?

"Our government is crippled by inefficiency, corruption, and overcentralization." Even after structural adjustment, the state performs many crucial functions. But a crisis grips public administration in many poor countries, and many people have lost confidence in their governments. The streamlining, and privatizing induced by free-market reforms will help. But is there not also a need for better incentives, anticorruption measures, and decentralization—for what might be called the structural adjustment of government itself?

"We face ethnic (tribal, caste, communal) inequalities. We probably always had them, but now they are impossible to ignore." With freer markets and freer flows of information and moves toward democracy, many countries find that ethnic inequalities and discrimination become a primary concern. We have become aware of these issues recently in the Soviet Union and in Eastern and Central Europe, but they are almost universal. In most countries of Latin America, Africa, and Asia, poverty is concentrated in certain social groups, and prejudice is widespread. What can be done to reduce economic and educational inequalities among groups?

These are some of the issues taking center stage in economic policy making in the developing world. Notice that they go beyond the debate over the relative powers of state and market in economic life. During the 1950s and the 1960s, most economists and aid donors advocated an interventionist state that would mobilize and manage the nation's resources. This was necessary, they argued, because markets failed in developing countries. In the 1980s and 1990s, the pendulum has swung the other way. Most economists and aid agencies now argue that the private sector should take the lead in economic mobilization and management. The argument now is that governments fail in developing countries.

For what it is worth, I tend to agree with the latest swing of this pendulum. But I believe the debate must go beyond state versus market. The reality in developing countries is that neither market nor government works well. The agenda now is to make both work better.

This book tries to move the new agenda forward in three ways. First, I hope the book will help induce a *shift of focus* in the debate on development policies. As I said, the debate has tended to be at the level of "the role of the state"—the balance (or blend or mix) of state and market. I try to move below this argument, from a macro to micro level of analysis and action. Beyond stabilization and liberalization, a host of microeconomic and institutional measures are needed to improve the market. Beyond reducing government's scope, we need to improve its management through the application of better incentives and information systems. And beyond declarations of nondiscrimination and equal rights, we need to rethink the policies that influence prejudice and inequality.

Second, the book exemplifies a *mode of policy analysis*. I don't mean that the book provides the first example or that it's a perfect one, only that it illustrates a useful way to do analysis that is at once mind-stretching and humble.

With what mode of analysis does it contrast? A few key policy makers and analysts meet behind closed doors. Excellent models of the economy are trotted out. Decisions are based on parameters such as the interest and exchange rates, tariffs, taxes, and public investment. The analysis and the decision making are macro and top down, often with decisive foreign involvement and funding.

What do I propose instead? The new agenda's questions about improving markets and government are institutionally and culturally loaded. Their solutions will involve more participation by line officials, businesspeople, and ordinary citizens. Analytically, the issues require micro-level rather than macro-level analysis—or so I contend. This book imports qualitative insights from areas of economics not often applied to development—the so-called new industrial economics (Chapters 3–5, 9), the new theory of the firm (the principal-agent model plus a little bit of the new labor economics (Chapters 7 and 8), and the economics of discrimination (Chapters 10–12). In each case, these models stress imperfect information and its corrosive effects on incentives.

From these models I derive a set of frameworks for policy analysis. There is no illusion here of a formal model from which optimal parameter values are derived under restrictive assumptions. Instead the frameworks are designed to guide inquiry and stimulate debate, so that policy makers and citizens may be more creative in solving their own inevitably unique problems. Their purpose is heuristic. If they can stimulate more and better frameworks, all the better—for I recognize the partial and imperfect nature of those presented here.

The frameworks are complemented by case studies of successful or at least interesting efforts to deal with the problem at hand. Working through examples is the best way I know of fostering creative problem solving, and the book includes cases from Bolivia, Brazil, India, Indonesia, Malaysia, Pakistan, Peru, and the Philippines, plus shorter examples from many other countries.

Without wishing on a star, I would hope the book does one more thing: help us to *reconceptualize underdevelopment.* Past theories of economic development have focused on capital formation, getting prices right, class structure, center-periphery relations, and many other factors. Without denying their relevance, this book suggests a different cut. Information and knowledge are at the heart of development; underdevelopment is bound up with ignorance and uncertainty. More concretely, individuals and societies with the lowest levels of information and of information-processing capabilities will likely also be the poorest. This is a probabilistic statement, not a deterministic one, and it does not mean that information is everything or that it alone explains malfunctioning markets, inefficient governments, and institutionalized discrimination. The reader will notice that the book's frameworks for policy analysis include many other factors. But I believe we will see in the next decade an explosion of interest in the informational bases of development, not only in economics but in other fields as well.

Thus, the seemingly disparate topics in the book are linked in several ways. They are emerging as crucial issues in the era after free-market reforms (although they have long been present). They go beyond the usual debates over state versus market, and they may provide a provocative if incomplete way of reconceptualizing the role of the state in economic development. They invite a different kind of policy analysis, one that is more participatory and open-ended, emphasizing frameworks and check-lists and case studies more than formal modeling. They have at their core a problem of imperfect and asymmetric information, a fact that may in turn suggest new hypotheses about economic progress and backwardness.

Summary of Conclusions

In recent years the trend toward free-market reforms has spread worldwide; some have even called it a revolution. Eastern and Central Europe and the former Soviet Union provide the most dramatic new examples, but many developing countries of Africa, Asia, and Latin America have been the pioneers. For example, Senegal began its "structural adjustment"—the switch from state-dominated economic strategies to an emphasis on free markets—in 1980. Bolivia's remarkable reforms came like thunder in 1985, in the midst of inflation that exceeded 25,000 percent. The transitions have not been easy or complete, and the problems developing countries now face may be a harbinger of what the former communist nations can expect.

For example, even five or ten years after free-market reforms, in many countries of the third world the new strategy has hardly benefited the poor. Moreover, economic inequalities among ethnic groups remain large and increasingly are the source of political problems. Governance has become a key issue, not only because of the new importance of democracy in these countries but because the success of free-market reforms turns out to hinge on good public management. Yet the public sectors of developing countries often exhibit grave deficiencies: adverse incentives, corruption, and over-centralization.

Why have these problems proved so stubborn, and what can policy makers do to address them?

This book begins with the difficult features of developing countries that the textbooks often overlook. The assumed conditions of perfect competition are often lacking, especially in markets affecting the poor. And the hoped-for conditions of good governance are lacking too.

Development strategies now must adjust to these realities—and do something about them.

1. Making Governments Work Better

One lesson of free-market reforms has been this: For markets to work better, government must also work better. This lesson has been a surprise to some people who, like the author, welcome the withdrawal of the state from many areas of economic management and control. But it makes sense both in theory and in practice. Most markets don't work well all by themselves; or to put it another way, only part of the problem is getting government off the backs of workers and entrepreneurs.

Take Bolivia, for example. The economy is dominated by mining and hydrocarbons, whose economics do not favor completely unregulated private sector exploitation. Ecological issues are paramount, which means public policy should play a key role. Illegal industries such as cocaine distribution, and illegal activities such as smuggling, play havoc with many areas of economic life and demand a governmental response.

In Bolivia, as in every other country, government must remain a major actor in macroeconomic policy making, infrastructure, and social programs—not to mention defense and foreign policy. Successful liberalization requires the highly skilled public management of privatization and related policies, new efforts to protect the environment, and the sophisticated regulation of newly freed capital markets and banking systems. Free markets require legal systems, grades and standards, and property rights, all of which governments must help to provide.

Unfortunately, governments in most developing countries fail to live up to these vital missions. This book analyzes three sets of ways to do better.

- Public sector incentives must be linked to achievements. For example, leaders can work with public employees to redefine objectives, to generate information about how well objectives are being met, and to create financial and other rewards for the achievement of objectives.

- Practical campaigns must be launched to reduce corruption. Successful examples do exist, and they carry some common themes, among them: Fry a big fish first, then help redefine objectives and measures of success, and then set up information systems to help identify various forms of corrupt and illicit behavior.

- Overly centralized governments must be restructured. But this does not mean simple-minded decentralization. Instead, both theory and successful cases show that certain functions of a government agency should be decentralized while others should be kept in the capital. Again, the improvement of systems of information and incentives turns out to be crucial to successful administrative reform.

Here and with the topics noted below, *Adjusting to Reality* takes a practical approach. It points to success stories and the lessons they can teach. And it provides analytical frameworks designed to help policy makers and citizens think through the needed reforms.

2. Making Markets Work Better

In addition to explaining why governments have to work well in order for markets to work well, this book focuses on an often overlooked category of market failures, those involving imperfect information.

Many examples of markets failing to serve the poor can be analyzed in terms of poor information. The poor and the traders who serve them often lack good information about prices, standards, and rules of trade. I underscore the importance of measuring quality—of goods and services, of employees and credit risks, of students and teachers.

Sellers, buyers, and governments can work together to create richer systems of information, which in turn will enable free markets for products and labor and credit to work for the poor. Government's roles are multiple. They include the informational infrastructure (such as communications); grades and standards; and the implementation of commercial codes, property rights, and rules concerning contracts and advertising.

Some of government's most intriguing roles in making markets work better are indirect. In many ways, the public sector can facilitate competition and contracts, in particular by helping to generate, provide, certify, and disseminate information about quality.

3. Overcoming Group Inequalities

A third reality to which development policies must adjust is the persistence of ethnic poverty and discrimination. Although economic growth and improved services help the poor, group differences remain and seem to grow more explosive even as markets and states become more free.

Here, too, information provides a new perspective on the causes and possible cures. Information plays a dual role in the plight of economically backward groups.

- Under conditions of imperfect information, both markets and merit systems can actually reinforce rather than remove group differences. When information about the qualities of individuals is scarce, economic actors rely on group information. The result is often a form of institutionalized discrimination.

- A profound source of ethnic disadvantage may be informational—certain groups may lack data about prices, quantities, and qualities in the markets for goods and labors; they often speak different languages; they may lack knowledge about laws and regulation; some are removed from modern devices of information transmission; and many are hampered by poor education and learning skills.

A promising way to attack these disadvantages is to improve information. Better information about the abilities and achievements of individuals—combined with labor markets and personnel systems that make hiring and firing easy and permit the adjustment of pay to performance—will reduce institutionalized discrimination.

In sum, "adjusting to reality" means:

- transcending ideological debates over the theoretical advantages of state versus market, even over the proper balancing of state and market

- going beyond the free-market macroeconomic reforms that characterize "structural adjustment"
- focusing on the realities of the *institutions* of both state and market
- finding ways to make state and market institutions work better and together
- facing up to uncomfortable problems, such as government corruption, ethnic inequalities, and markets that fail to serve the poor

These changes will not be easy, nor will they happen quickly. They will require a new kind of policy analysis, one that emphasizes participation, the use of case studies, and the application of theory in order to kindle creativity rather than to derive answers. In this quest, economists can play a humble though mind-stretching role; and microeconomics may well turn out to be more important than macroeconomics.

Adjusting to Reality puts information at the heart of economic development. Increasingly, those left behind economically are those who lag in access to information and ability to process it. This holds true for individuals, organizations, groups, and countries. The importance of information and information processing suggests new ways of reconceptualizing not only the role of government but also the nature of economic development itself.

An Overview of *Adjusting to Reality*

Bolivia's three-time former president, Victor Paz Estenssoro, recently described some of the reasons for his country's remarkable about-face in economic policy. Paz Estenssoro was the architect of both the Bolivian Revolution of 1952 and the New Economic Policy of 1985—economic programs as different from each other as state interventionism and reliance on market forces. "The situations were different," he explained. "In the 1950s, the business interests were very great but they had no creative functions, only big mining where the money left the country. In the countryside, there were property holders of the feudal type. The economy was therefore stagnant. In these circumstances it was essential for the state to play the leading role."[1]

In 1952 Paz Estenssoro implemented changes that were watched and admired by many who favored state-led growth, nationalization, and land reform. But in August 1985, when at the age of seventy-eight Paz Estenssoro took office for the third time, hyperinflation and corruption were digesting the Bolivian economy. He shut down mines he once had nationalized, freed prices he once had controlled. The private sector, not the state, he declared, would henceforth play the leading role in economic development.

"Over time the state grew," he explained. "It became inefficient and corrupt. It no longer played its role. In fact, it became a negative force. The state retarded the economy and, through deficits, created inflation that reached 25,000 percent when I took office in 1985. The intervention of the state created the conditions for corruption and bribes."

The Free-Market Revolution

In its remarkable free-market reforms, Bolivia has not been alone. The trend is worldwide, and some have called it a revolution. Eastern and Central Europe and the Soviet Union are highly visible examples, but in many ways Africa, Asia, and Latin America have been the pioneers. By 1991 more than fifty developing countries had undertaken some form of "structural adjustment."

The move toward freer markets, though welcome, does not magically solve the problems of poverty and underdevelopment. In early 1991, five and a half years after the start of the New Economic Policy, Bolivia's economy remained lifeless. Inflation was quickly brought under control, but per capita consumption has continued to fall. Private investment has not picked up. It is said that most of the poor are worse off than before Bolivia's free-market reforms. And in this, too, Bolivia is not alone. Around the globe the results of the free-market revolution have so far proved disappointing. And remarkably, around the world one hears a similar litany of the reasons why:

- Free markets have been declared, but they have not yet reached the poor.
- Government is crippled by inefficiency, corruption, and overcentralization.
- Ethnic (tribal, caste, communal) inequalities, which have always been there are now impossible to ignore.

Markets for products, credit, and labor need to be democratized. If they are not, only the rich and the foreigners and the criminals will benefit from structural adjustment. Part of the solution is getting government off the backs of the small producer and businessperson. But only part. Many of the markets that the poor in developing countries face are highly imperfect. What, people are asking, can be done to make markets work better?

Even after the free-market revolution, the state must perform crucial functions. Inevitably, government must remain a major actor in macroeconomic policy making, infrastructure, and social programs—not to mention defense and foreign policy. Successful liberalization itself requires the highly skilled public management of the privatization process, new efforts to protect the environment, and the sophisticated regulation of newly freed capital markets and banking systems.

For free-market reforms to work, government institutions must also work. But a crisis grips public administration in most poor countries, and many people have lost confidence in their governments. What can be done to improve incentives, control corruption, and decentralize public administration?

With freer markets and freer flows of information, ethnic inequalities and discrimination become a primary concern. These issues trouble the former Soviet Union and Eastern and Central Europe, but they are pervasive in other countries as well. Within most countries of Latin America, Africa, and Asia poverty is concentrated in certain social groups, and prejudice is widespread. What can be done to reduce economic and educational inequalities among groups?

These are some of the issues taking center stage in policy making around the world. Notice that these issues transcend the usual debate over the relative powers of state and market in economic life. This debate has too often focused on shortcomings of the market (as trumpeted by advocates of a strong state) or on shortcomings of governance (as cited by proponents of untrammeled markets). But the reality is that in developing countries both markets and governments fail. If economic reforms are to endure, they must go deeper than declaring markets to be free. Beyond market versus state we find market *and* state, indeed market thanks to state; and we must turn to the challenge of making both market and state work better.

The Checkered Record

The reasons why both markets and government tend to malfunction in developing countries are complex. Consider Bolivia. Major sectors of the Bolivian economy—mining hydrocarbons, highland agriculture, transportation, extralegal activities, credit, and agricultural markets—display classic "market failures," such as increasing returns, common property resources, externalities, adverse selection, and more. Economic theory and practical experience tell us that sectors with these characteristics will generate problems if left entirely to the play of market forces.

But the existence of market failures does not by itself prove that the government should take over these sectors. The underlying conditions are not favorable for efficient government either. Especially in poor countries, the public sector exhibits "nonmarket failures," such as adverse incentives, corruption, and overcentralization.

The problem is not with the theory of the free market or the theory of the efficient, benevolent state. The problem is that because the underlying conditions are so difficult in developing countries, many markets don't work well and much of government doesn't work well either. How might development policies adjust to these realities—and perhaps go about changing them?

Another adjustment may also be necessary. Poverty is a principal concern in development strategies, or should be. Freer markets and improved public services will in the long run benefit the poor. But one discovers in Bolivia a phenomenon found in many other developing countries. Certain groups in the society are disproportionately and stubbornly impoverished, undereducated, unhealthy, and discriminated against. In Bolivia's case, the economically and educationally backward groups are indigenous peoples—the Aymara and Quechua "Indians" and various people of the lowlands. Many markets do not effectively reach such groups, nor do many political institutions, the press, or the legal system. Even as economic and political institutions are liberalized, societies stratify by race, ethnicity, community, religion, and tribe.

The ethnic concentration of poverty raises new questions about economic development and the proper role of the state. Beyond the state's efforts to invest in human capital, promote distributive justice, and combat poverty through social programs, should special steps be taken to deal with the ethnic character of poverty and discrimination? What have we learned from experience around the globe about public policies aimed at reducing ethnic inequalities?

Information and Making Markets Work

Markets fail for many reasons; in this book I focus on one broad category of problems, those pertaining to information. Consider an example: agricultural markets. Farmers in developing countries often have little knowledge of market conditions. In one African study, three quarters of maize farmers "had no idea of the current maize price and were unwilling even to hazard a guess." Studies show that traders often have "defective market information."[2] Weights and measures—more generally, standards and clear rules of the game—are often imperfect or even absent. *Quality* is difficult to measure and certify, and the result is adverse incentives for producers and consumers. As a consequence, many agricultural markets are unstable, and marketing margins are large. Informational imperfections become points of leverage for oligopolists and exploiters of various stripes. For all these reasons, free-market reforms take too long to reach the poor. Structural adjustment at the macro level may leave micro structures unaffected.

Poor people (and others) adapt to these problems in many ways—for example, using interlinked transactions, reputation, various kinds of rules, family or other ties to help enforce contracts, and gifts. Scholars have analyzed the evolution of firms, of norms and customs, of trade associations and universities and informational media, as responses to defects in markets, particularly problems with information. In developing countries, markets affecting the poor are often overlaid with competition-restricting practices that persist in part because they provide information, reduce risk, enable credible commitments, and facilitate quality control.

As markets expand and specialize, many of the institutions and mechanisms of the bazaar and the primitive society are economically inefficient and unfair. Some scholars, observing what they deem to be "exploitation" and the restriction of trade by informationally advantaged traders, have called for state control of trade. The market is so imperfect in developing countries, they say, that it needs strict regulation, if not replacement. This impulse has sometimes combined with an anticommerce world view to produce a calamitous cycle of government interference with rural markets.

Other scholars, shocked by this cycle and enchanted by the hum of the competitive equilibrium, believe in an opposite solution. One must dismantle the trade-restricting institutions not only of the state but also of primitive societies and bazaars. "If only competition were set free," they say. but the informational perspective cautions against mistaking the symptoms for the underlying causes. The reasons for the state controls and "primitive" economic institutions may run deep: among other things, information problems. And if information remains poor, setting markets free may result in inefficiency and injustice, especially for the poor.

As I employ it, "information" has broad scope. It includes the data relevant to economic decisions and the ability (both societal and individual) to generate, distribute, guarantee, analyze, and process it. It is the *effective use* of information in economic decisions that matters. Perhaps we can do better by focusing on the underlying conditions of markets in developing countries, including the ineffective use of information.

One broad category of informational problems in developing countries concerns the measurement of the "quality" of a good or service, a worker, or a credit risk. Information about quality is often scarce and expensive, asymmetrically held among the parties in transactions, and subject to guileful manipulation. The buyers and sellers in markets can themselves take steps to overcome these problems. To do so, they sometimes heed the help of a third party, such as government; and government itself may take direct measures to improve the informational content of markets. Markets are not automatically efficient.

It is surprising how often these problems with "free markets" are overlooked in development policy making. For example, a recent World Bank review of all its projects in agricultural marketing from 1974 to 1985 identifies and criticizes a common assumption in Bank work that "the existing marketing system operates satisfactorily." In fact, most markets don't—as Bank-funded projects eventually discovered. The report laments that "there has been little attempt to improve the efficiency and transparency of private sector marketing mechanisms. This is reflected in lack of attention to market news services, legally defined grades, weightbridges and regulated weights and measures, credit for small traders, and improved market structures." Most projects failed, the report concludes, because the World Bank and the countries receiving these loans seemed to assume that "if it is produced, it will get sold."[3]

"Notable omissions," said the report,"include the lack of any measures for providing a framework within which markets could operate more efficiently—commercial legal code, regulation or inspection. . . . It is striking how little attention seems to have been given to the government's role in providing standardized weights and measures, defining and policing nationally recognized quality grades, collecting and disseminating timely price information, or encouraging competition."

In a similar vein, at the end of a study of markets in Africa and Asia, researchers from the International Food Policy Research Institute concluded that governments should allow private trade "to work freely. Market development policies improving legal and physical facilities and flow of information should be another component of this transition."[4] These policies include "development of market places, dissemination of price and production information, introduction of standard grades and weights, [and] maintenance of law and order in transport channels and markets," among others.

So the practical question becomes: What can governments do to improve flows in markets? There are many possibilities, which are summarized in Table 1. The alternatives include setting up and enforcing "rules of the game" that encourage information sharing and cooperation by reducing transactions costs and risks—for example, laws, weights and measures, and commercial codes. They include various state roles in quality assessment and control, the development and dissemination of market information, research and development, education (the dissemination of knowledge and also the development of information-processing skills, materials, and technologies), communication, and the production of goods and services. The state may intervene directly or indirectly—the latter meaning creating the legal and institutional framework for private parties to solve informational problems by themselves—or both.

Each option entails costs as well as benefits. To say that government may have a role in these areas is not, of course, to say in a particular case that it should, or in any case that only it should. Each situation deserves both the creative rethinking of alternatives and the careful analysis of benefits and costs. (Two case studies in the book permit a detailed examination.)

Amid all the details, a central point should not be lost: Fair and efficient markets do not occur by accident. They are the products of, among other

TABLE 1

Quality and Markets: A Matrix of Problems and Policy Solutions

	Policy Solutions		
Problem	**What Sellers Can Do**	**What Buyers Can Do**	**What Government Policy Makers and Other Third Parties Can Do**
Quality varies across sellers	Form producers' groups with quality standards	(No policies required)	Regulate quality of products, processes Facilitate the formation of producer and consumer groups Regulate producer and consumer groups
Information is imperfect and asymmetric	Provide buyers with information about products, processes (e.g., through advertising, labeling, samples) Create brand names whose products share quality characteristics	Gather information Use consultants, information services	Improve the informational infrastructure (e.g., communications [hardware]; the development and dissemination of standards [software]; laws and policies) Measure quality
Sellers have incentives to mislead	Offer contingent contracts (e.g., warranties) Invest in reputation for quality Merge with the buyer (integrate forward)	Threaten retaliation Become a repeat customer Link the purchase of one product with the purchase of others from the same supplier Merge with the seller (integrate backward)	Put into effect and enforce contingent contracts Require high-quality sellers to stay in the market Offer arbitration (e.g., to settle a price dispute) Set prices for different qualities of goods Nationalize production or distribution

things, intelligent laws and public policies and environments rich in information.

Structural adjustment means that the role of the state in economic development is cut back and more reliance is placed on market forces. These are, I believe, welcome changes. But adjusting to reality means recognizing the shortcomings of markets as they are found in developing countries—and doing something about them. Government has a crucial role to play, not just in the "standard" case of public goods and environmental externalities, but also to help markets become competitive, efficient, and just. For free markets to work better, government must also work better.

Improving Governments

Just as the informational perspective provides insights into the problems of markets in developing countries, so too does it suggest approaches to three classic problems of government: inefficiency and adverse incentives, corruption, and overcentralization.

What I call "incentive myopia" is the chronic oversight of the importance of incentives in the public sector. A crisis of public incentives plagues many poor countries. Pay and performance are virtually unconnected. The resulting inefficiencies threaten not only public services but also economic reforms themselves.

Politics, custom, and sheer poverty constrain public sector incentives. Public services are notable for the difficulty of defining objectives and measuring results. Civil service rules limit the use of financial incentives. Despite all these obstacles, experience shows that improvement is possible. It suggests that leaders work with public employees to redefine the objectives being sought, to generate information about how well the objectives are being met, and to link part of the compensation of public officials to the achievement of those objectives. *Adjusting to Reality* describes various ingenious success stories of improved public sector incentives, despite all the obstacles.

Until recently, corruption was a virtually taboo subject in development studies. But as its cancerous effects have grown, eroding incentives and nourishing a predatory elite, corruption has become impossible to avoid. Many governments are launching initiatives against corruption. International agencies are offering support as never before. In the past two years, international aid organizations such as the World Bank, the U.S. Agency for International Development, the Ministère de la Cooperation (France), and the United Nations Development Programme have initiated seminars and programs dedicated to corruption and what to do about it.

But what *can* be done to reduce bribery, extortion, kickbacks, influence peddling, fraud, and other illicit activities? Simply declaring a campaign against corruption is no solution. Structural adjustment will presumably help reduce corruption by reducing the state's monopoly powers in economic life. (We should note, however, that privatizing a state monopoly may simply rename the corruption.) Government in any case remains, and on its success is dependent the success of free-market reforms.

Corruption can never be eliminated, only reduced; and the approach I recommend is to treat it as a problem of policy and management in addition to one of morality and law. One begins by disaggregating the many forms of corruption—bribery, extortion, kickbacks, nepotism, fraud, embezzlement, speed money, and many others. One analyzes in each case the structures of incentives and information facing public officials. It proves useful for would-be anticorruption fighters to work through five categories of tools for controlling corruption between public "agents" (or employees) and "clients" (or citizens) (see Table 2):

1. Selecting the agents (and training them)
2. Altering the incentives facing agents and clients (for both efforts and results)
3. Collecting and processing information on the agents' and clients' efforts and results
4. Restructuring the agent-client relationship (for example, reducing monopoly powers, reclarifying rules and procedures to circumscribe agents' discretion, changing decision making, and indeed, redefining the mission of the organization)
5. Raising the moral costs of corruption (for example, with ethical codes and changes in the organizational culture)

TABLE 2

Controlling Corruption: A Framework for Policy Analysis

A. Select agents.
  1. Screen out the dishonest (using past records, tests, predictors of honesty).
  2. Exploit outside "guarantees" of honesty (use networks for finding dependable agents and making sure they stay that way).

B. Set agents' rewards and penalties.
  1. Change rewards.
    a. Raise salaries to reduce the need for corrupt income.
    b. Reward specific actions and agents that reduce corruption.
    c. Use contingent contracts to reward agents on the basis of eventual success (e.g., forfeitable nonvested pensions, performance bonds).
    d. Link nonmonetary rewards to performance (training, transfers, perks, travel, publicity, praise).
  2. Penalize corrupt behavior.
    a. Raise the severity of formal penalties.
    b. Increase the principal's authority to punish.
    c. Calibrate penalties in terms of deterrent effects and breaking the culture of corruption.
    d. Use nonformal penalties (training; transfers; publicity; blackballing; loss of professional standing, perks, and travel privileges).

C. Obtain information about efforts and results.
  1. Improve auditing and management information systems.
    a. Gather evidence about possible corruption (using red flags, statistical analysis, random samples of work, inspections).
    b. Carry out "vulnerability assessments."
  2. Strengthen information agents.
    a. Beef up specialized staff (auditors, computer specialists, investigators, supervisors, internal security).
    b. Create a climate in which agents (e.g., whistle-blowers) will report improper activities.
    c. Create new units (ombudsmen, special investigatory committees, anticorruption agencies, inquiry commissions).

C ·olling Corruption (continued)

3. Collect information from third parties (media, banks).
4. Collect information from clients and the public (including professional associations).
5. Change the burden of proof, so that the potentially corrupt (e.g., public servants with great wealth) have to demonstrate their innocence.

D. Restructure the principal-agent-client relationship to leaven monopoly power, circumscribe discretion, and enhance accountability.

1. Induce competition in the provision of the good or service (through privatization, public-private competition, competition among public agents).
2. Limit agents' discretion.
   a. Define objectives, rules, and procedures more clearly and publicize them.
   b. Have agents work in teams and subject them to hierarchical review.
   c. Divide large decisions into separable tasks.
   d. Limit agents' influence (change decision rules, change decision makers, alter incentives).
3. Rotate agents functionally and geographically.
4. Change the organization's mission, product, or technology to render them less susceptible to corruption.
5. Organize client groups to render them less susceptible to some forms of corruption, to promote information flows, and to create an anticorruption lobby.

E. Raise the "moral costs" of corruption.

1. Use training, educational programs, and personal example.
2. Promulgate a code of ethics (for civil service, profession, agency).
3. Change the corporate culture.

Generating reform when many leaders are themselves corrupt is hardly automatic; here aid donors may play a catalytic role. Even in the best of circumstances, controlling corruption requires political will and great managerial skill. Reducing corruption is not easy, but as shown by the success stories I have studied, it is possible, even when the head of state is corrupt. Information and incentives are at the heart of the solution.

Overcentralized government, in part the result of the strategy of state-dominated economic development, is another obstacle to free-market reforms. But decentralization is not easy or automatic. Experience shows that it often degenerates into inefficiency and chaos. The classic explanations for the failures of decentralization are a lack of local technical and managerial capabilities and insufficient political will. I recommend focusing instead on information and incentives. When information is plentiful about public services and their results, and when incentives can be linked to such information, then both "agents" and "clients" can be given more authority and discretion over services. In the opposite case, decentralization is likely to fail.

Administrative integration is one response to the interlinked, holistic nature of development problems. A classic example is integrated rural development, in which various services ranging from agriculture to health to education to infrastructure are administratively combined in a single agency or project. When information and incentives are poor, then administrative integration may be tempting as the only way to induce necessary coordination across activities. But the costs of administrative integration have frequently been greater than foreseen. Many of the benefits of specialization are often sacrificed, and the sought-after coordination often proves elusive.

A detailed analysis of both issues leads to two general conclusions. (In the book, these points are again underscored by analyzing real cases of success.) First, what to decentralize or integrate, and how, should depend on the environment, in particular on the availability of information and incentives. Decentralization is most likely to be successful when information is rich and incentives are powerful and linked to results. Under these same circumstances, coordination can be achieved without administrative integration.

Second, beyond adapting to the environment, one may try to change it. If information is scarce, how might it be created and shared? If ultimate outcomes are impossible to measure, what short-run proxies might be employed? How can incentives be increased and linked to results? Each of these steps of course entails its own costs, so there is again no magic formula or blueprint for reform.

In these analyses of government failures, information and incentives take center stage: "The problem in government is not lack of accountability, as is sometimes suggested," writes Steven Kelman," but the nature of the accountability. Government people do not lead sheltered lives: they are indeed held accountable, often publicly and painfully so, if they violate rules, even if the standards of probity themselves were not violated. . . . What is missing is demand for accountability for the quality of the government's performance."[5]

Why is accountability so difficult in government, especially in developing countries? Part of the answer lies in difficulties of measurement. Many public sector results are intrinsically harder to gauge than private sector performance. Consequently, we rely on rules and procedures to guide public officials; we measure the inputs rather than the outputs of public systems. Part of the problem is inherent in the nature of public goods; but not all of it. We have not been aggressive in developing partial and proxy measures of public sector success, or in empowering clients and citizens with marketlike proxies such as vouchers. We have also been unwilling to link pay to performance in the public sector.

If, as we have seen, government's strengths are needed to improve markets, so too are ideas from the market needed to improve government. "Efficient organizational design," argues Paul Milgrom, "seeks to do what the system of prices and property rights does in the neoclassical conception: to channel the self-interested behavior of individuals away from purely redistributive activities and into well-coordinated, socially productive ones. The success that a society's institutions have in achieving this objective is a major determinant of its economic welfare."[6] The next decades, I believe, will see a revolution in the provision of transparent information about public performance and the development of new ways to link incentives to those results. This, in turn, will enable governments to play their appropriate roles in freeing private markets and fostering economic development.

Overcoming Ethnic Inequalities

Information also provides a new perspective on one of the most intractable problems of development—the persistence of ethnic poverty and discrimination. *Within* most developing countries, certain ethnic groups are economically and educationally backward. They tend to remain that way despite efforts at assimilation, despite educational and public health programs, despite affirmative action. Though economic growth and improved public services alleviate ethnic poverty, they do not overcome group inequalities, at least in the short and medium run. An analysis of the different strategies employed by Peru, Brazil, and Malaysia reveals the stubbornness of ethnic differences in incomes, employment, and education. Peru tried to assimilate its "Indians." Brazil adopted no ethnically based policies, while Malaysia promulgated perhaps the world's strongest programs of preferential treatment, in this case on behalf of the majority Malay ethnic groups. Yet in all three cases, ethnic inequalities in income and ownership remained huge.

Information plays a dual role in the plight of economically backward groups. First, under conditions of imperfect information, markets and merit systems may reinforce rather than remove group differences. When individual information is scarce, economic actors rely on group information. The result is a form of institutionalized discrimination.

Second, a profound source of their disadvantage may be informational—they lack data about prices, quantities, and qualities in the markets for goods and labor; they often speak different languages; they lack access to institutional knowledge about laws and regulation; they are removed from modern devices of information transmission (telephones, for example); they are measurably poorer in certain learning abilities.

Based on economic models of discrimination, one can develop another framework for policy analysis concerning the problem of ethnic inequalities and discrimination. It consolidates policy alternatives into four categories:

1. Through direct redistribution, reduce group inequalities in social outcomes such as power, employment, ownership, and income—or deflect attention from those inequalities.
2. Reduce underlying group differences in behavior, human capital, culture, and so forth.
3. Improve information and market functioning.
4. Change or influence where and how economic and political decisions are made. (Here enter preferential treatment programs.)

After considering the many policy options that fall into these four categories, I find the third category particularly attractive. Especially in developing countries, group inequalities are partly the result of imperfect information in both markets and merit systems. Better information about the abilities and achievements of individuals—combined with labor markets and personnel systems that make hiring and firing easy and permit the adjustment of pay to performance—will remove many kinds of institutionalized discrimination.

Information and Institutions

The realities of international development mean that we must go beyond free-market economic reforms at the macroeconomic level. Markets involve *institutions*, which must be developed. Buyers and sellers act together in some of these institutions—for example, trade associations and consumer groups—but in even the freest markets the state plays many roles. The time has come to transcend debates over "state versus market," even over the proper balancing of state and market. The market and the state must work together. Even from the narrow perspective of economic development, a priority is to make government work better.

This will mean going beyond many past efforts to improve public administration, which have ignored some of the economic and informational realities of government in developing countries. Past efforts have stressed administrative reform, training, institution building, foreign advisers, and better equipment; they have usually left out incentives for performance. This is analogous to past efforts to boost private sector production without raising producer prices. Incentives are equally crucial in the public sector, especially given the current crisis of public sector salaries in developing countries.

Improving government will also mean facing up to corruption as a problem for policy and management—not squeamishly avoiding it as too sensitive, or considering it exclusively a problem of morals, education, or better laws. It will mean reconfiguring the overcentralized state apparatus. Effective decentralizing and administrative integration will go beyond slogans to a hard-headed analysis of various public activities and functions and the information and incentives attending each.

We must also strive to overcome taboos about ethnicity, not just for the sake of social stability or to avoid ethnic violence but for economic development. Policy analysis on this subject must break out of certain intellectual conventions. Ethnic poverty is not just the result of discrimination; on the other hand, discrimination is not just the result of irrational racial hatred but can become institutionalized. Advantaged groups do not necessarily benefit from ethnic disparities; on the other hand, competition is not the automatic solution to all forms of discrimination. If our efforts to fight poverty are to bear fruit, they must neither overlook nor misunderstand the ethnic dimensions of disadvantage.

Recasting Policy Analysis

For issues like those we have been discussing, the usual approach to policy analysis and foreign aid may itself have to be reexamined. One way to convey the change I have in mind is through a stylized comparison.

Consider the way structural adjustment policies have been formulated. Government officials, perhaps in collaboration with international aid agencies, recast macroeconomic policies involving interest rates, prices, tariffs, and commerce. In some countries, including Bolivia, key decisions have been made behind closed doors by a handful of senior officials and politicians. Implementing the reforms is of course another matter; but the style of decision making is centralized and top-down, involving the adjustment of certain parameters or changing of laws. U.N. experts have written many national plans; World Bank officials have designed many structural adjustment programs.

Such decisions are the dream of a certain style of policy analysis. The analyst is given the objectives, alternative actions, and constraints; then her or his job is to evaluate the effects of the various actions. From the analyst's calculations a prescription is derived. The analytical problem is the leap from givens to prescriptions, from the "if" to the "then." This conception borrows from economic theory. Under idealized assumptions, economics is able to derive powerful statements about optimal tariffs and taxes and exchange rates. Seduced, the policy analyst may accept a lot of unrealistic restrictions on the "if" for the thrill of an unassailable "then." And so it is that policy analysis may feed top-down decision making and the exercise of authority, whether of the old planning variety or the new macroeconomic reforms.

But the issues we have been addressing are different. They tend to be microeconomic, decentralized, and institutionally loaded. They involve information—its creation, dissemination, sharing, and processing. Because of the richness of the problems and the need to involve those on the line and at the bottom in their solution, a different style of policy analysis is needed. In the case of public sector reforms, for example, experience shows that it is crucial for public employees to participate in the design of incentive schemes and of campaigns against corruption. The intellectual problem is transformed: how to discover and how to be more creative about the objectives, the alternatives, and the constraints. These are no longer given, but are to be generated or enhanced; the analysts' job is to understand, expand, and enrich the "if."

According to this view, policy analysis provides not so much a set of answers that politicians should adopt and bureaucrats should implement, but a set of tools and examples for enriching the appreciation of alternatives and their consequences.

How might such creativity best be kindled through policy analysis? Theoretical research can play a role; so can careful descriptions of existing problems. But one may also wish to go further. Although there is no optimal policy for all countries under all conditions and one country cannot simply copy another, we can learn from each other's experience. Case studies, particularly of success, can spark problem-solving skills. So can analytical frameworks that help to organize the myriad dimensions and alternatives of the problem—even if inevitably any single framework can be criticized as inexact and incomplete. Recognizing a new goal for policy analysis and policy dialogue—the kindling of creativity rather than the provision of the "right answer"— may in turn spark economic analysis with even greater applicability.

New Kinds of Leaders

The issues we have been discussing may require a different kind of excellence in leadership as well. In the past, people have talked of leadership in economic policy making in terms of political will and technical excellence (as of a national plan or a free-market reform package). What is important now—after structural adjustment and after the declaration of democracy—is the application of *technical skills* to questions of *value*. We have talked of democratizing markets, invigorating government institutions, controlling corruption, decentralizing, and fighting discrimination and ethnic inequalities. Other key issues could be added to the list— for example, improving the rule of law, enhancing popular participation, creating solidarity and compassion, and protecting human rights. For all these tasks, developing countries need *moral leaders* of a new kind.

By moral leadership I do not mean just the sort provided by the church or social opinion makers. I mean the use of economic, political, and managerial skills to attack the vices and imperfections that keep societies underdeveloped. To many people the linking of such skills to moral problems may seem self-contradictory. Especially in developing countries, people are fond of saying "We need a change of mentality," or "You can't do anything because the whole system is immoral." These statements contain a germ of truth, but too often they lead to a defeatist conclusion. "In our societies," they shrug, "the problems are too deeply rooted. We can't get anywhere with economics or political changes or management."

But the fact is that countries *have* been able to foment competition, democratize markets, curb corruption, clean up systems of justice, sanitize campaign financing, and improve the incentives for public officials. Even poor countries. Yes, we should try to change our mentalities; yes, we should work toward profound systematic change. At the same time, we have plenty of work to do in the here and now of practical policies.

Ours is the time of stirring speeches on behalf of free markets and free elections. But we are learning that simply declaring markets or elections to be free is not enough.

We have to make sure the markets are deepened and open to the poorest. Democratizing markets will require special efforts in the areas of credit as well as better systems of information about market prices and qualities. Otherwise, supposedly free markets will be inefficient and unfair.

We have to make sure that elections are democratic. This will require, for example, the public funding of campaigns and rigorously enforced spending limits (which incidentally reduce some of the incentives for corruption by the party in power); democratic education; the promotion of civic associations; and scrupulously efficient elections. Otherwise, supposedly free elections can be shams. We have to make sure that governments once elected have efficient administrative mechanisms to pursue justice, provide public services, and promote economic competition.

In all these cases, we need more than reforms at the macro level. It will take intelligent policies, institutional reforms, and shrewd management to fulfill the promise of the new freedom.

We need less government, but we need much better government: this is the new reality. In this domain, the success of Bolivia's Social Emergency Fund (FSE) has taught some grand lessons. In this remarkable program, the government provided strong, centrally administered quality controls and follow-up, but decentralized both the formulation of projects (to local communities) and their construction (to the private sector). The FSE had excellent, highly motivated personnel. It attracted them with the mystique of service, a flexible bureaucracy, good pay, and promotions that depended on achievements. Even with the good pay and the excellent computers and communications equipment, the FSE's overhead costs were under 4 percent of the value of the public works it financed. (The United Nations charges other donors over 7 percent for administering their aid projects.) The FSE had higher apparent costs than the usual government agency, but it was also that much more efficient.

The FSE showed that good information and good incentives lead to superior performance. Why not elsewhere in government? In the public sector we have neglected the idea of incentives. At the same time that we extol "the magic of the marketplace" and "getting prices right," we pay civil servants less and less in real terms, and we don't link what they are paid to what they achieve. Various alternatives are being tried in a number of countries. The idea can in principle be applied to teachers as well as municipal officials, to functionaries of the development banks as well as customs agents.

These reforms go beyond the macro level of elections, laws, budgets, and macroeconomic policies, as important as these are. Today's new agenda includes changes in institutions that will permit truly free markets and truly free and fair elections: a freer and stronger press; a recast judicial system, from police force to Supreme Court; programs to overcome ethnic and racial inequalities; government bureaucracies energized through decentralization and a focus on measurable objectives and incentives linked to their achievement; and a campaign against corruption and abuse. These changes will not be easy. They constitute as much of a challenge as dismantling a state-dominated economic system in favor of freer markets. In both cases, the transition will be difficult, and success will not be immediate. But if the 1980s were the decade of the structural adjustment of the private sector, I believe the 1990s will be the decade of the structural adjustment of govemance.

It is in this sense that developing countries need moral leaders. To achieve moral reforms we need practical politics and economics and management. The leadership style will not be one of top-down decisions made by a few behind closed doors. It will instead involve the mobilization of participation and careful thinking by govemment officials, the private sector, and the people.

Rethinking Economic Development

These reflections may lead to a rethinking of the causes of underdevelopment. Past theories of economic development have focused on capital formation, getting prices right, class structure, center-periphery relations, and many other factors. Without denying their relevance, I suggest a different cut. Information and knowledge are at the heart of development; underdevelopment is bound up with ignorance and uncertainty. More concretely, individuals and societies with the least access to information and with the lowest levels of information-processing capabilities will also be the poorest. This is a probabilistic statement, not a deterministic one, and it does not mean that information is everything or that it alone explains malfunctioning markets, inefficient states, or institutionalized discrimination. The book's many frameworks for policy analysis include a host of other factors. But I believe we will see in the next decade an explosion of interest in the informational bases of development.

When we recognize that less-developed countries are characterized by incomplete and imperfect information, we can take a fresh look at features of local economies that are often ascribed to tradition or to forms of class domination. Many rural institutions, such as sharecropping and interlinked markets, can be seen as adaptations to markets with poor information and high risks. "With regard to trade in the ordinary sense—trade of unlike articles between strangers—in primitive society," writes Richard A. Posner, "transaction costs are presumably high because of the costs of information regarding the reliability of the seller, the quality of the product, and trading alternatives (that is, the market price). However, institutions have arisen which reduce these transaction costs," including gift-exchange, "customary" prices, the transformation of an arm's length contract relationship into an intimate status relationship," and "a buyer's deliberately overpaying a seller in order to induce the seller to deal fairly with him in the future."[7]

So too can one analyze the sometimes bizarre institutions of the bazaar where, says anthropologist Clifford Geertz, "information is poor, scarce, maldistributed, inefficiently communicated, and intensely valued. . . . The level of ignorance about everything from produce quality and going prices to market possibilities and production costs is very high, and much of the way in which the bazaar functions can be interpreted as an attempt to reduce such ignorance for someone, to increase it for someone, or to defend someone against it." Geertz emphasizes clientelization (or repeated purchases) and "intensive rather than extensive bargaining" as the key institutional responses to informational problems.[8]

Indeed, culture itself can be viewed, if never fully apprehended, through the lens of information. The causality runs in both directions. Culture and its stipulations and conventions can be viewed as providing solutions to market failures, especially when information and enforcement problems make coordination difficult. As information becomes cheaper and more widespread and other systems of enforcement begin to work well—such as the law—then cultural norms start to break down. At least, this is the hypothesis.

Information has little value without information processing capabilities. For an individual, these capabilities are a complicated function of many factors: inherited abilities, conditioning, education, and access to information processing technologies, among others. The acquisition and development of these capabilities also depends on how they are rewarded—on features of the economy and political power.

Individuals form organizations and societies. These can also be said to have information processing capabilities. How well organizations learn is again a function of many variables, including the opportunities to make profits through greater knowledge, technology, power structures, culture, and policy choices.

Since people and organizations and perhaps entire societies differ along these various dimensions, we may expect two things. First, they will adapt differently to problems of imperfect and incomplete information. Given the same structures of information, different processing capabilities will lead to different outcomes. And the different processing capabilities will lead to different adaptive strategies. For example, people or organizations or societies with less information processing capability will tend to rely more on rules, conventions, conformity, and hierarchy, other things being equal.

Second, people and organizations and societies will differ in their capability to take advantage of a modern, open, information-intensive economy. Confronted with profit opportunities that depend on information processing capabilities, those with less capability will tend to lag economically.

And so the informational perspective opens new approaches to the explanation of economic inequalities among people, institutions, cultures, and social systems. Beyond inequalities in capital and labor and natural resources, we must turn to information and the ability to process it, in part developed, conditioned, and invested in according to a host of factors, including development policies.

Notes

1. Victor Paz Estenssoro, interview with the author, December 7, 1990. All subsequent comments of Paz Estenssoro are taken from the same interview.

2. William O. Jones, "Measuring the Effectiveness of Agricultural Marketing in Contributing to Economic Development: Some African Examples," *Food Research Institute Studies in Agricultural Economics, Trade and Development* 9, no. 3 (1970); cited in Harold M. Riley and Michael T. Weber, "Marketing in Developing Countries," Working Paper no. 6, Rural Development Series (East Lansing: Michigan State University, Department of Agricultural Economics, 1979): 11. Jones cites a number of studies showing "defective market information" in Nigerian and other African markets in *Marketing Staple Food Crops in Tropical Africa* (Ithaca, N.Y.: Cornell University Press, 1972): esp. chaps. 6, 9, and 10.

3. World Bank, Operations Evaluation Department, *Agricultural Marketing: The World Bank's Experience, 1974–85*, World Bank Operations Evaluation Study (Washington, D.C., July 1990): 47, 48, 2, 3. Another recent World Bank study, this one of markets in Africa, makes similar points. "Finally, the conditions needed for the private sector to operate efficiently, including free entry, information, and factor mobility, access to credit and transport of private traders and small producers must also be considered. The paper documents that it is not so much the principle of privatization as the sequencing, phasing, and pace of privatization and price liberalization that have been the problematic issues. Donors—who indiscriminately supported the growth of the public sector in the 1970s—have not shown adequate appreciation of the preconditions necessary for the private sector to operate competitively or of the steps needed to be taken by the public sector to ensure the competitiveness of the private sector." Uma Lele and Robert E. Christiansen, "Markets, Marketing Boards, and Cooperatives in Africa: Issues in Adjustment Policy," MADIA Discussion Paper 11 (Washington, D.C.: World Bank, December 1989): 4.

4. Raisuddin Ahmed and Narendra Rustagi, "Marketing and Price Incentives in African and Asian Countries: A Comparison," in Dieter Elz, *Agricultural Marketing Strategy and Pricing Policy* (Washington, D.C.: World Bank, 1987): 115–16.

5. Steven Kelman, *Procurement and Public Management: The Fear of Discretion and the Quality of Government Performance* (Washington, D.C.: American Enterprise Institute, 1990): 14–15.

6. Paul Milgrom, "Employment Contracts, Influence Activities, and Efficient Organizational Design," *Journal of Political Economy* 96, no. 1 (February 1988): 58–59.

7. Richard A. Posner, "A Theory of Primitive Society, with Special Reference to Law," *Journal of Law and Economics* 23, no. 1 (1980): 25–27.

8. Clifford Geertz, "The Bazaar Economy: Information and Search in Peasant Marketing," *American Economic Review Papers and Proceedings* 68, no. 2 (May 1978): 30, 29.

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