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Summary and Synthesis: 1991 Research Projects

Working Paper Series

The objective of the Institute for Policy Reform is to enhance the foundation for broad based economic growth in developing countries. Through its research, education and training activities the Institute encourages active participation in the dialogue on policy reform, focusing on changes that stimulate and sustain economic development. At the core of these activities is the search for creative ideas that can be used to design constitutional, institutional and policy reforms. Research fellows and policy practitioners are engaged by IPR to expand the analytical core of the reform process. This includes all elements of comprehensive and customized reforms packages, recognizing cultural, political, economic and environmental elements as crucial dimensions of societies.

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Summary and Synthesis: 1991 Research Projects

Thirty research projects, conducted primarily by Institute for Policy Reform senior research fellows, with additional contributions from advisory board members, and staff, represent the beginning of a continuing search for creative ideas that can be used to design constitutional, institutional and policy reforms which enhance the foundation for broad based economic growth in developing countries. Research areas for 1991 projects included: Privatization of Firms in Transition Economies; Financial Markets in Transition Economies; Taxation, Public Finance and Safety Nets in Transition Economies; Historical Lessons of Reform; Risk and Insurance Institutions in Developing Economies; Health and Education; Political Economy and Policy Reform; and New Theoretical Paradigms for Policy Reform.

Individual copies of research papers and further information on the Institute research program may be obtained by contacting: Institute for Policy Reform, Suite 350, 1400 16th Street NW, Washington, DC 20036; Phone (202) 939-3450; Fax (202) 939-3458

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Introduction

> *The Institute for Policy Reform's research projects expand the intellectual base of policy projects in developing countries.*

The Institute for Policy Reform promotes research that enhances the foundation for broad-based economic growth in developing countries. IPR, through its senior research fellows program, supports scholars whose work expands the analytical core of the reform process. During the first year of the cooperative agreement with the Agency for International Development (AID), 30 projects were completed under the senior research fellows program.

The research project topics were chosen because of their timeliness, importance, and relevance. For example, in response to the political events in Eastern Europe and the liberalization of these economies, several studies were conducted to analyze and evaluate the transition process within them. George Akerlof examines the reform process in East Germany; Ronald McKinnon evaluates both privatization and fiscal and monetary policies; David Newbery discusses the safety net and sequencing the transition; Nick Stern explores potential problems related to taxation in transition economies and evaluates the lessons from establishing public financing in China; and Jean Tirole presents a study of ownership in transition economies.

Other senior research fellows added historical perspective to current economic problems, such as Anne Krueger, who examines the theories underlying development policy in the 1950s and Turkish trade policy reform in the 1980s; Todd Sandler, who presents a retrospective summary of Mancur Olson's *The Logic of Collective Action*; Erik Thorbecke, who analyzes Indonesia's adjustment to economic development; and Sebastian Edwards, who presents an overview of economic growth and trade policy.

Several projects explore topics more traditional to economics, such as Rob Townsend's comparison of the structure of village and regional economies in Thailand with risk and insurance in village India, and T. Paul Schultz's discussion of family planning and educational investments in men and women. The political economy of economic reform is analyzed by Gordon Rausser and Leo Simon in their model of transition processes and by

John McMillan, Gordon Rausser, and Stanley Johnson in their study measuring the size and timing of economic benefits that follow an institutional reform. Three senior research fellows examine new theoretical frameworks for understanding development problems. George Akerlof discusses procrastination and obedience; Oliver Williamson studies comparative economic organization and institutional aspects of economic reform; and Erik Thorbecke analyzes types of market fragmentation in developing countries.

Taken together, these studies represent the basis for a continuing search for creative solutions that can be used to design constitutional, institutional, and policy reforms for developing countries. This report presents a summary of these projects completed under the auspices of IPR's senior research fellows program.

Privatization of Firms in Transition Economies

The newest challenges in development, highlighted by recent political developments in Eastern Europe and in other areas of the world, involve the process of transition in liberalizing economies. These economies are characterized by centrally owned and planned industries, many of which would not be economically viable if they were privately operated.

> *Rapid infrastructure investment programs and employment bonuses are recommended to ease adjustment in East Germany's privatization.*

One example of the economic problems of government-operated firms is highlighted in Akerlof's, "East Germany in from the Cold: The Economic Aftermath of Currency Union." Akerlof finds, using previously unpublished data, that only firms employing 8 percent of the labor force are economically viable. Through interviews of East German workers, Akerlof determines that while lower wages in East Germany will not induce migration to West Germany, unemployment in East Germany will induce migration. These two problems - the negative value of many firms, which is causing the privatization process to move slowly since valueless assets are difficult to sell, and the potential large migrations from East to West Germany induced by a search for secure employment - define the economic challenges facing German policymakers. To overcome these problems, Akerlof proposes: (1) a rapid infrastructure investment program to add value to firms before they become private, and (2) a program of bonuses to promote employment in East German enterprises and mitigate migration to West Germany.

> ***The tariffication of quantitative restrictions followed by their gradually phasing down is recommended for privatizing economies.***

The problem of negative value added is also addressed by Ronald McKinnon in "Liberalizing Foreign Trade in a Socialist Economy: The Problem of Negative Value Added." In a traditional Stalinist economy, the implicit structure of tariff equivalents "cascades" downward from very high levels for the domestic production of finished consumer goods through manufactured intermediate products, and then through industrial raw materials and energy, whose production is negatively protected because of implicit export taxes (or import subsidies). This highly cascaded structure of implicit tariffs raises effective protection in finished goods to the point where most manufacturing will exhibit negative value added at world market prices. In such circumstances, a move to free trade could provoke the collapse of most domestic manufacturing industries - no matter how the exchange rate is set, and even though some segment of this industry might eventually be viable at world market prices.

Reforms to make commercial policy more explicit should accompany efforts to make currency convertible on current account. McKinnon suggests the simultaneous tariffication of quantitative restrictions on competing imports and the elimination of implicit export taxes on energy and material inputs as the economy moves quickly to a market-based system. Once made explicit, the highest tariffs in the cascade can then be phased down step-by-step to zero over a preannounced five- to ten-year time span. The newly marketized economy would then converge to free foreign trade at a more deliberate pace, one that better adjusts to the problem of overcoming distortions from the preexisting system of protection.

> ***Developing new firms and strengthening existing small firms is a key to East European transformation.***

Fischer's study, "Privatization in Eastern European Transformation," examines the process of privatization in Poland, Hungary, and Czechoslovakia. The standard approach to privatization in these countries has involved selling small commercial and industrial firms, making corporations of large industrial and commercial firms, and privatizing financial intermediaries responsible for agriculture and land use. Within this approach, disputes remain regarding the role of holding companies or mutual funds, demonopolization of former state monopolies, the role of foreign capital, and the management in the privatized firms.

Fischer concludes that the successes of small-scale privatization and the extraordinary growth of very small firms suggests that the key to the long-run transformation of these economies may lie less in the privatization of the very large industrial firms than in the development of new firms and the growth of existing small firms. For this reason, Fischer suggests that rapid progress in other areas, such as the creation of a suitable legal environment, price decontrol, industrial deregulation, and trade liberalization, is as important to the development of a vibrant private sector as privatization of large firms.

Political imperatives are as important as economic judgments in sequencing the transition.

The theoretical desirability of privatization is questioned by Joe Stiglitz in, "Theoretical Aspects of the Privatization: Applications to Eastern Europe." A previously developed theorem (the Sappington-Stiglitz theorem), states that only under highly stringent conditions can a government be assured that its objectives in efficiency and equity can be achieved. Achieved, that is, at the same time that it acquires full market value from its sale of firms. Stiglitz argues that since there is neither a theoretical basis (due to the Sappington-Stiglitz theorem) nor an empirical basis (leveraged buy-outs in the United States in the 1980s did not increase efficiency of these firms) for believing that firms will operate more efficiently once they become private, the case for privatization is mainly a political one: privatization increases the "transactions cost" of obtaining government subsidies and government protection from competition. Thus, sequences of moves in the transition process are dictated as much by their political imperatives - for instance, the concern about weakening the power of the state - as by economic judgments.

The payoff from providing market incentives can be rapid and substantial.

Lessons learned in the privatization of the Chinese economy are summarized by Athar Hussain and Nicholas Stern in "The Role of the State, Ownership and Taxation in Transitional Economies." Hussain and Stern argue that, while China is not a model for other countries, its experiences provide three main lessons. China's experience suggests that the payoff to providing market incentives to households and small farms can be rapid and large. Since institutions are not in place to collect taxes, "limited private ownership" of state-owned firms with positive revenue flows may be desirable and feasible in the transition. As a final lesson, building new institutions for privatization and revenue collection can be a lengthy process, as opposed to using of the institutions that implement macrostabilization, which can be done quickly.

Enterprises should be demonopolized before they are privatized.

Once an economy has made a committed to reforms, the issue becomes the order in which they should be implemented. David Newbery argues, in "Sequencing the Transition," that reforms be sequenced to meet three criteria: ensuring or restoring macroeconomic stability, sequencing to avoid the emergence of undesirable collusions, and maintaining support for completing the reform process. An application of these principles to Soviet-style economies suggests that enterprises should be demonopolized before they are privatized, so that firms will not retain the power and incentive to devote higher profits to wage increases, investment, and consumption. Creating decentralized and autonomous institutions (such as independent central banks, anti-monopoly offices, and regulatory agencies) is crucial to creating credible commitments to policy regimes, and hence to entrenching the reform process.

Financial Markets in Transition Economies

Both Akerlof's and Fischer's analyses of privatization in Eastern Europe highlight problems of financing and capital markets in this transition. Stiglitz's "The Design of Financial Systems for the Newly Emerging Democracies of Eastern Europe," and Tirole's "Ownership and Incentives in a Transition Economy," provide theoretical models of financial markets in this privatization process.

> *Completely new financial institutions need to be created in East European countries.*

Stiglitz's study emphasizes the links and distinctions between the two functions of capital markets: intertemporal trade and risk spreading. The economic theory of financial markets is applied to five problems particular to the transition of the economies of Eastern Europe. The privatization of financial institutions, many of whom had their deficits made up through subsidies from the government, will establish a "hard" budget constraint in financial institutions. Since historically the banks and other so-called financial institutions did not perform any of the central functions (other than mediating transactions) traditionally associated with financial institutions, completely new institutions need to be created. Inherited loan portfolios are a problem when valuing the assets of a financial institution since the value of a loan portfolio depends on government policies. Will the government honor loans taken out by state enterprises and will it insist on those purchasing state enterprises to honor debts? The financial sector needs to be carefully regulated to avoid significant errors either in the direction of inducing too much or too little competition in that sector. Finally, because of the limited ability of government (and depositors) to monitor banks, ownership restrictions that limit potential conflicts of interest and the abuse of banks' fiduciary responsibilities seem desirable.

Independence from interest groups is a main attraction of foreign aid in the transition process.

Tirole's research examines some incentive and market structure features in western economies that are a contrast to features of transition economies and conditions an assessment of which features of western economies can be carried to the transition environment. Seven possible adjustment scenarios are evaluated: public ownership, employee management under absentee state ownership, entrepreneurship, diffuse private ownership, hands-on domestic private ownership, hands-on foreign ownership, and scrappage. Because of the high level of uncertainty in firms' environments and the non-stationarity of their levels that are likely to characterize the environment of adjustment in Eastern Europe, five implications are presented and discussed: (1) stock markets will work poorly in the initial phase due to highly volatile prices; (2) most competition-oriented restructuring ought to take place before privatization; (3) the threat of capture of government decision making by interest groups is, during the transition period, more serious in Eastern Europe than in western economies; (4) the main attraction of foreign aid for the transition process may not be expertise, but rather commitment and independence from interest groups; and (5) the stock market must be introduced appropriately at the beginning of the mature phase.

Taxation, Public Finance, and Safety Nets in Transition Economies

The change in economies from a reliance on central planning to a reliance on markets involves changes in the ways revenues are collected and in how social insurance is administered. IPR research projects analyze the changes in tax bases and revenue collection in transition economies, evaluate the safety net in Hungary, and examine appropriate monetary and fiscal policies to control inflation during liberalization.

Diversification of taxes and equity are two guidelines for tax systems in transition economies.

The economic transition from a planned to a market economy involves a transition in tax systems. Nicholas Stern analyzes public finance and taxation issues in transition economies, with a particular application to China in "Economic Reforms and Public Finance in China." The pros and cons of taxes depend on the composition of the economy's GNP, its institutional structures, and the ways these are likely to change (and the effect of tax structures on possible changes). Tax reform in a transition economy has to begin with the premise that the government's control over the functional and personal distribution of incomes is much weaker than it was under the command economy. This suggests two guidelines for tax design: (1) there should be a diversification of taxes (and also nontax revenue sources), and (2) equity should become a central consideration in tax design.

Means-tested cash transfers can mitigate the distributional effects of reforms in order to sustain political support for their continuation.

The process of privatization and reform is also likely to create adverse distributional impacts created as social income determination is replaced by the market and public finances become strained. David Newbery's study, "The Safety Net During Transformation: Hungary," analyzes options for Hungary's safety net programs to affect income distributions. Since Hungary relied primarily on subsidized wages to implement egalitarian policies, reforms to make wages determined by economic factors are likely to result in increased inequalities. Newbery shows how means-tested cash transfers in areas such as minimum pensions, family allowances, and supplementary benefits can mitigate the distributional effects of reforms and sustain political support to continue them.

A tax collection agency and a self-financed financial sector are proposed for fiscal and monetary stability in transition economies.

The endemic loss of macroeconomic control and appropriate monetary and fiscal measures to control inflation during liberalization are analyzed by Ronald McKinnon in "Financial Control in the Transition from Classical Socialism to a Market Economy." Under classical socialism, all the means of production are state owned, and output targets are set by a Stalinist system of central planning; wages and prices are also centrally determined. If liberalization from classical socialism is to succeed, moves to dismantle the apparatus of central planning, to decontrol prices, and to privatize property need to be supported by a proper sequence of fiscal, monetary, and foreign exchange measures.

At the outset of liberalization, an organized internal revenue service, a major government bureaucracy for collecting taxes from households and liberalized enterprises, should be in place. In privatizing the financial sector, reliance on self-finance is the simplest technique for imposing financial restraint on liberalized enterprises while simultaneously increasing the productivity of physical capital. When the price level has been stabilized and the sums the government must borrow from the banking system are significantly reduced, the financial system could enter a second stage where commercial banks begin limited and fully collateralized short-term lending to liberalized enterprises according to the "Real Bills Doctrine." Finally, financial arrangements governing foreign exchanges should parallel and complement these domestic tax and monetary arrangements.

Macroeconomic Policies and Economic Reform

The success or failure of microeconomic policy reforms often turns on compatible macroeconomic polices. Both Yair Mundlak's and Sebastian Edwards's studies contribute to the definition of successful macroeconomic policies.

> *Policies affect growth through resource allocation and resource accumulation.*

The potential for economic policies to influence economic performance is analyzed by Yair Mundlak in his paper "On Intermediate Run Growth." In models where economic growth is determined by technological change and resources devoted to technology-changing activities, the ability of economic policies to increase growth is limited. Examples from experiences with policies and growth in Chile and Argentina are used to develop an alternative framework to measure and understand the role of policies in influencing economic growth. To examine this role of policies, it is necessary to show the channel through which they affect growth. Using a choice-of-techniques model of endogenous technological change, Mundlak argues that policies have both a direct effect on productivity, which works through resource allocation, as well as an indirect effect, which works through resource accumulation.

> *Monetary reform, sound tax systems, initially undervalued currencies, and de-indexed labor markets are recommended for East European economies.*

Policy reform in many developing countries is difficult, due in part to a lack of understanding of the dynamics of changes. Sebastian Edwards, in "Stabilization and Liberalization Policies in Eastern Europe: Lessons from Latin America," discusses some Latin American lessons on stabilization that can be useful to better understand the policy options available to the former socialist nations. The four most important macroeconomic problems faced by the former socialist economies are: (1) alternative ways of dealing with the monetary overhang and rationing; (2) fiscal equilibrium and reducing inflation; (3) use of fixed nominal exchange rates to anchor the anti-inflationary process; and (4) the role of indexing and labor markets in the adjustment process. These solutions are suggested: (1) a monetary reform is preferred to a price jump to eliminate the money overhang; (2) a tax system not vulnerable to inflation should be created to avoid fiscal imbalances; (3) exchange rate based stabilization programs carry a danger of provoking a major overvaluation, suggesting that a starting point should be one of undervaluation; and (4) efforts to de-index the labor market should be maintained throughout the stabilization process.

Historical Lessons of Reform

Lessons from previous experiences with policy reforms, both successes and failures, are essential to the successful design of future policy reforms. In an effort to understand the effect economic ideas can have on economic policies and the process by which economic policies are altered, Anne Krueger reviews the history of economic development policy in the 1950s. Todd Sandler reviews a book by Mancur Olson that emphasizes recent contributions to the theory of collective action. An additional study by Krueger analyzes successes and failures in policy reform in Turkey, while Thorbecke suggests lessons that can be learned from policy reform in Indonesia. Sebastian Edwards uses a cross-country database to analyze the contribution of open trade policies to economic growth.

Economic concepts are important to the design of policy reform.

Anne Krueger, in "Ideas Underlying Development Policy in the 1950s," discusses two hypotheses of the role of economic ideas in changing economic policy. Under the first hypothesis, economic policies are determined by the political powers of competing groups, with little potential for economic advice to influence the outcome. The competing hypothesis is that economic ideas and analyses are important inputs to the policymaking process. Krueger tests these hypotheses by examining the consistency of economic policies with economic ideology in the 1950s. If policies are inconsistent with a current understanding of development, ideology is an unimportant influence on policy formation. If however, development thought is consistent with current policy practices, then it is possible that development thought has important, and perhaps even powerful, influence on policy. While hindsight shows that the 1950s view of government as social guardian, encouraging import-substitution as the mechanism of development needed refinement, the practice of protection and distrust of the public sector was consistent with economic thought of the time.

Reforms that changed Turkey to an outwardly oriented economy have been a major catalyst for growth.

Turkey's trade policy reforms are also an historical setting for Anne Krueger's analysis, "The Economics of Turkish Trade Policy Reforms in the 1980s." Krueger argues that understanding both bottlenecks and the interactions of inappropriate policies are keys to reforms to improve economic performance. By the late 1970s, Turkey was caught in a web of policies - government spending, pricing of state enterprises, protection of domestic industry, and overvaluation of the exchange rate - that reinforced its inflationary spiral. Turkey's response to this crisis differed from responses to crises in 1958 and in 1970 by addressing the underlying causes of the economic crises: measures taken in 1980 included liberalizing foreign trade, departing from the import-substitution strategy, and diminishing the role of state economic enterprises. These reforms reoriented the Turkish economy from an inward-looking, insulated one to an outwardly oriented economy in which exports have been a major catalyst for growth.

Economies with open trade regimes have higher economic growth rates.

Sebastian Edwards, in "Trade Orientation: Distortion and Growth in Developing Countries," analyzes the case for free trade in a cross-section of developing countries. Edwards finds, using several different measures of economic openness and of intervention, that developing countries in the period 1970 to 1985 with more open trade regimes also had higher economic growth rates. These results are interpreted in a theoretical framework linking economic growth with exposure to foreign knowledge where an economy's ability to appropriate world technical innovations is assumed to depend on the economy's degree of openness.

> ***Since individual rationality is often insufficient for collective rationality, proper institutional design is important.***

In "*The Logic of Collective Action*: A Retrospective View," Todd Sandler reviews Mancur Olson's book *The Logic of Collective Action*, and evaluates research that it has inspired. The basic premise of this book is that individual rationality is not sufficient for collective rationality. Three themes support this premise: (1) group size is, in part, behind collective irrationality; (2) group asymmetry, in terms of membership tastes and/or endowments, is related to collective irrationality; and (3) group irrationality may be overcome through selective incentives and institutional rules and designs. These principles are illustrated and applied by Sandler in his paper. These applications reinforce the validity of the three basic tenets of collective action. Applications concern military alliances, foreign aid, philanthropy, the growth of nations, labor unions, international responses to terrorism, the commons, strategic trade policy, international organizations, and public inputs. Since the underdeveloped world is especially prone to common problems, such as gathering firewood for fuel causing deforestation, it is particularly interesting to see how incentives in institutions may be structured to overcome this common problem.

> ***A stable and credible regime, combined with rural development policies, produced successful adjustment in Indonesia.***

The Indonesian adjustment experience between 1982 and 1988 provides the background for Erik Thorbecke's "The Indonesian Adjustment Experience in an International Perspective." After a short initial contraction, fast-paced growth resumed and poverty alleviation continued throughout the adjustment phase. Indonesia also managed to diversify significantly from resource-based primary exports to manufactures. Indonesia's rapid and successful response is attributed to the stability and credibility of the regime, stemming from sustained commitment to growth, rural development and poverty alleviation, relatively even land distribution, and a rice boom that preceded the crisis and the strategy that was adopted. The relationship Thorbecke finds between institutions (a stable and credible regime), policies (rural development and poverty alleviation), and Indonesia's economic successes emphasizes the importance of a comprehensive approach to designing policy reforms.

Risk and Insurance Institutions in Developing Economies

In poor, developing economies, social institutions to mitigate the risk of crop failures or other income shocks are particularly important. Understanding these institutions is an important first step toward designing policies that seek to transform these economies without imposing the burden on poorer individuals.

Welfare-improving interventions are possible in rural Thai insurance markets.

Policy reforms in developing countries often rely on the nature and level of risk in these economies and how residents respond to this risk. Rob Townsend studied risk-sharing institutions in rural areas. In "Understanding the Structure of Village and Regional Economies," Townsend compares results from previous studies of medieval and Indian villages with his own survey of the structure of poor and high-risk Thai villages. By contrasting the relatively "thin" markets of Thai villages with Southern Indian villages, possibilities for welfare-improving interventions, leading to increased co-insurance in Thai villages, are revealed. Most important, these interventions are possible without requiring, as is sometimes argued, perfect information between insurers.

Local financial markets in Southern India are good, if not perfect.

A related question, that must come before the policy question, is how good or bad are the existing insurance and credit institutions in rural economies are. Townsend evaluates Indian institutions in "Risk and Insurance in Village India." If these institutions are functioning properly, then an individual's level of consumption should, through insurance contracts with others, vary with the village's average level of consumption. Using household data from three villages in southern India, Townsend concludes that a significant co-movement in consumption suggests that local financial markets there are good, if not perfect. Several anomalies exist, however, including the low impact of income on consumption and the effect on consumption of time-varying characteristics such as land holdings.

Health and Education

Health and education policy have been a traditional instrument of development assistance. T. Paul Schultz explores ways in which these instruments may be further sharpened.

> *Channeling funds to remote, low-income regions can improve the impact of fertility programs in Thailand.*

Many policy reforms have a goal of reducing population growth in developing countries. T. Paul Schultz, in "Assessing Family Planning Cost Effectiveness: Applicability of Individual Demand-Program Supply Framework," considers the distinction between two sets of factors that affect fertility - community supply of family planning services and constraints on parent demand for birth - and assesses how this distinction guides the empirical design of family planning programs. The supply-demand framework can clarify the segments of the population for which the program is likely to be more or less cost-effective, and can help to determine how the effectiveness of various program activities may change with the scale of the program and interact with other program elements and population characteristics. Evidence from Thailand demonstrates that family planning expenditures are subject to diminishing returns and that marginal returns differ across elements of the program and segments of the population. This private, nonprofit program was most effective among rural, poor households. A policy implication of these findings is that the program's overall impact could be increased if user fees were introduced or raised to recover more of the cost of services and contraceptive supplies delivered to urban, high-income households. These funds could then be channeled into providing additional subsidized services to more remote, low-income regions.

Women's schooling should be subsidized more strongly than men's schooling.

The idea of comparing economic returns across groups as an indicator of program effectiveness is applied by T. Paul Schultz to the question of education in "Differences Between the Returns and Investments in the Education of Women and Men." Estimates from Thailand, Cote d'Ivoire, Ghana, and elsewhere, as well as the United States, are compared to assess how corrected returns to schooling are related to the wide variation in school investments between women and men across contemporary low-income countries. These estimates confirm that private wage returns are of a similar magnitude for women and for men. In addition to increasing the market productivity of workers, investments in schooling also contain external benefits to society such as reduced child mortality, improved child nutrition and schooling, and decreased fertility and population growth. Since these externalities are primarily associated with educating women, there is a strong case for society to subsidize greater investment in women's schooling than in men's. Governments and societies need to be apprised of the long-run productive and social opportunity costs of investing less in the education of girls than in boys.

Political Economy and Policy Reform

Current trends in development assistance emphasize the role of institutions and of political economy. IPR studies contribute to this understanding, emphasizing the economic benefits of pluralistic, market-oriented institutions.

> *Transition processes should have pluralistic, decentralized, and market-oriented characteristics.*

Research by Gordon Rausser and Leo K. Simon, "The Political Economy of Transition in Eastern Europe: Packaging Enterprises for Privatization," abstracts from the details of individual privatization proposals, and provides a general conceptual perspective that provides an overview of the entire transition, integrates the major issues currently being debated in the literature, and can be used to assess the relative strengths and weaknesses of alternative proposals. A special feature is Rausser and Simon's focus on the process by which government policies and enterprise-level decisions are made, rather than on the specific content of policies and decisions. The model is designed with five basic premises in mind. First, the privatization process in Central and Eastern Europe can be conceptualized as a multifaceted conflict among a variety of interests representing workers, management, claimants to property rights based on prior ownership, foreign investors, representatives of different groups in the distribution chain, and other groups. The nature of the procedures provided for resolving these bargaining problems will have a profound impact on the ultimate performance of the post-privatization economy. Second, Rausser and Simon emphasize the importance of modeling the dynamic interaction between the economic and political facets of massive privatization programs. Third, given the heterogeneous conditions facing state-owned enterprises, no one method of privatization will dominate all other methods in all instances. Fourth, if the ultimate goal is to establish a pluralistic, decentralized, market-oriented system, then the transition process itself should have similar characteristics. Fifth, both political and economic benefits can be gained by expanding the range of players that have the opportunity to participate in the transition process.

Economic benefits to institutional reforms are significant, but occur with a lag.

The empirical basis for policy reform prescriptions suggested by the institutional approach to economic growth and development is explored by John McMillan, Gordon Rausser, and Stanley Johnson in "Freedoms and Economic Growth." Their focus is the relationship between institutional reforms, measured by changes in a country's political rights or civil liberties, and economic growth. In addition to finding support for the idea that institutional reforms can cause increases in economic growth, four major implications emerge: (1) the economic benefits of freedom reforms are systematic and significant; (2) economic benefits, in the form of increased growth, occur with a substantial lag after reforms in political rights or civil liberties are initiated; (3) types of reform likely to be successful are different for various geographic regions of the world; and (4) civil liberties are particularly advantageous to economies in low growth years.

New Theoretical Paradigms

An important step in the search for creative ideas that can be used to design constitutional, institutional, and policy reforms is a questioning and expanding of traditional paradigms. Akerlof's study provides an alternative to the model of rational decision making traditionally found in economic analysis. Williamson's projects are important expansions of the new institutional approach to economics while Thorbecke's paper provides an understanding of market fragmentation in developing countries.

Limiting initial overcommitment and providing constant, contradictory information avoid losses from procrastination.

Usual models of economic behavior used in policy reform analysis assume individualistic values with forward-looking rational expectations. These assumptions, while excellent at clarifying economic principles, are not quite realistic in an environment of significant policy reform. This environment may be characterized more by individuals changing their minds and behavior as they respond to leadership and new ideas. George Akerlof's "Procrastination and Obedience" models repeated decisions with time-inconsistent behavior. Although each decision results in only small losses, the cumulative effect of a series of repeated errors can be quite large. Policy consequences of this type of behavior are illustrated with examples from savings, crime, substance abuse, politics, and bureaucratic organizations. Courses of action are reinforced by selectively eliminating information contrary to that course of action, so that initial psychological overcommitments are reinforced. Limiting initial overcommitment and providing constant, contradictory information are important instruments to avoid the losses resulting from procrastination and indoctrination.

Transaction cost economics can also be applied to non-Western and noncapitalist economies.

Policy reforms in developing countries have been hindered by the lack of appropriate institutional structures. An application of "The New Institutional Economics" is an analysis of these institutional structures. Oliver Williamson's paper "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives," extends and refines the apparatus out of which the new institutional economics works. He attempts to make it more responsive to four reported problems and critiques: (1) research into the institutional environment (emphasizing institutional rules such as customs, laws, and politics) and research into institutions of governance (focusing on the comparative efficacy of alternative generic forms of governance) has developed in a disjunctive fashion; (2) transaction cost economics deals with polar forms such as markets or hierarchies, but neglects intermediate or hybrid forms (long-term contracting, reciprocal trading, regulation, and franchising); (3) applications have emphasized measuring transactions to the exclusion of measuring governance; and (4) transaction cost economics have not been applied to non-Western and noncapitalist economies.

Institutions that support "high-powered" incentives are important in economic reform processes.

Transaction cost economics goes beyond the orthodox prescription for a reformed economy - which emphasizes the use of macroeconomic instruments to control inflation, the removal of price controls, currency convertibility, and the removal of trade restraints - and urges that the institutions of economic organization play a vital role in determining the success or failure of reform. Oliver Williamson examines the role institutions can play in economic reform in "Institutional Aspects of Economic Reform: The Transaction Cost Economics Perspective." Especially important are institutions that support high-powered incentives. The difference between genuine and simulated privatization is examined in this connection. Also crucial are credible commitments by the state to forestall the hazards of expropriation. The design of constitutions and of the judiciary are pertinent. Reform efforts can and have been defeated by overmanaging the process. The costs of good intentions (both benign and insidious kinds) need to be expressly taken into account.

> ***An increased similarity in the characteristics of items traded in socioeconomic attributes of actors, and in environmental elements will lead to decreased market fragmentation in developing countries.***

It has been widely observed that markets in developing countries tend to be more segmented than in developing countries. In "Markets and Transactions in Developing Countries," Erik Thorbecke, in collaboration with Peter Cornelisse, attempts to understand the underlying causes of the various forms of segmentation: parallel, curb, segmented, fragmented, black, and informal markets. Whether a market has a particular structure is not the primary goal of the analysis; instead, the causes of this fragmentation, and how these causes affect the operation of markets in a differential way are the key factors. Three sets of elements in different combinations shape distinct markets and help explain their operation. Characteristics of the item traded form one set of elements; socioeconomic attributes of the actors form another set. Characteristics of environmental elements are grouped into five subsets: (1) physical, location, and spatial elements; (2) technology and form of organization; (3) cultural aspects; (4) policy and legal elements; and (5) socioeconomic structure. This scheme is applied to derive topologies of market configurations for products, labor, credit, land, and foreign exchange. As markets evolve, they affect the elements and lead to new market configurations and transactions. Together with socioeconomic development, markets tend to become less fragmented, larger, and more integrated and interconnected. Understanding and anticipating this process is critical to designing successful economic policies in developing countries.

Themes for Future Research

From the experience of 1991's projects, and with input from AID policy professionals, ten research topics have emerged. These topics, organizing the overall research program of the Institute for Policy Reform, are:

- Democracy and Economic Systems Featuring Markets and Individual Incentives

  Understanding the connections between participatory political systems and open and participatory market systems will be useful in overall assessments of the USAID democracy initiative, and in suggesting areas of importance for more specialized, country-specific and conceptual work.

- Financial Balance and the Public Sector

  The monetary and fiscal balances in transition countries are closely tied to the scope of the public sector, choices of public goods, and public finance. Solutions to these problems involve a clear understanding of the decision process on public goods, the capacities that exist in these nations for altering taxation, and expenditure policies, and the institutions and technologies as they affect the public-private mix.

- Packaging Reforms, Mixing Policies and Institutions, and Reform Sequencing

  Often, host countries have been reluctant to adopt reforms that by themselves appear quite rational. The reasons for not pursuing these reforms must be explored if sustainable policy change that contributes to rapid economic growth and development is to be successful.

- Privatization, Legal Institutions, and Competitive Policy for Market Economies

  Successful privatization must be accompanied by antimonopoly policy that ensures that the forces of competition are active. In setting the transition process and in designing industry and trade policies that foster economic growth, it must be recognized that privatizing encourages changed behavior in the nonprivatized sectors, and may require quite different sets of regulatory, judicial and legal institutions.

- Indicators of Policy Performance and Democratic Pluralism

  In promoting policy reform to create the institutional environment for market-oriented economies and improve the efficient allocation of resources, there is a need to be able to show that investment in policy reform is a worthwhile activity. USAID needs to develop a mechanism for measuring the success or failure of policy reform initiatives.

- Economic Growth and Environmental Sustainability

  Many developing countries are experiencing problems of acid rain, deforestation, air and water pollution, wildlife extinction, and depletion of renewable natural resources. Knowledge of types of economic policies and incentives that can be used by donor countries to promote more efficient use of environmental resources can help USAID assist developing countries in identifying and managing environmental problems and in integrating environmental concerns into national economic development strategies.

- Customizing Institutions and Environmental Problems in Evolving Political and Economic Systems

  The resistance to change and exploitation of the environment may be a source of powerful interests and constituencies. Compensation, trade-offs, pricing, taxation, and permit schemes to manage the natural base, and other mechanisms necessary to facilitate policy reform, may be required to reverse the degradation of the environment in developing countries.

- Safety Net Measures and Individual Risk During Reform Processes

  Food security, food assistance, training and education, housing, and medical assistance are a part of the safety net package in many nations. It is important, however, that these safety net measures create incentives for participation in productive economic activities.

- Trade and Multinational Links Anticipated by Reforms and Extranational Negotiation

  Variations in agricultural and other basic commodity prices, trade policies, exchange rates, capital movements, technical change, and other factors that may not be under control of those initiating and conducting reforms can have major impacts on their success and sustainability. Conditional transition processes and even conditional reforms may be necessary for countries that face uncertain external conditions.

- Financial Mediation and Private Credit Markets

  Development assistance programs and projects in the credit area have often been unsuccessful. In part, this is because these programs have involved subsidized credit. Unfortunately, nonprice rationing systems supplant the interest rate in these cases and frequently work against the target group. More modern approaches focus on the financial institutions, mediation processes, and private lending organizations that are near the users of the credit, with the goal of identifying institutional changes to make the credit market operate efficiently and service the emerging private sector.

Results from the studies guided by these topics will continue the contribution made by the 1991 research projects in IPR's search for creative ideas to design constitutional, institutional, and policy reforms that enhance the foundation for broad-based economic growth in developing countries.

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