A New Paradigm for Policy Reform and Economic Development

Gordon C. Rausser

Throughout much of the world, significant institutional changes are in the air, wind, and water. Evidence is accumulating that democracy has won the political battle and that markets have won the economic battle. Some serious scholars have even argued that the history of thought about first principles, including those governing political and social organizations, has come to an end (Fukuyama). For those who hold this view, Hegel was simply too early in forecasting the end of the evolution of thought about such first principles nearly two centuries ago. The entire Marxian experiment was nothing more than a 150-year detour which corroborated Hegel's view that the "end of history" coincided with the emergence of liberal-democratic states following the French and American revolutions.

Regardless of whether the history of ideology is over, a new consensus on economic, political, and civil freedoms has emerged. This consensus means more than simply adjusting macroeconomic policy, achieving stability, and selling off a few government-owned enterprises in an attempt to set developing countries on a path toward broad-based economic growth. Instead, it means creating a vision of an open economy underpinned by an open polity; identifying and removing the obstacles to economic participation, obstacles that lock the ordinary citizen out of the game; enhancing the availability and utility of information resources by shaping incentives and helping to establish the basic rules of social transactions; encouraging more efficient organization of economic activity whether by market, hierarchy, or hybrid modes (Williamson) in ways that may lead to fundamental restructuring of an economy; and fostering institutional frameworks that expand the role of human choice and promote the full panoply of entrepreneurial energies.

In developing countries, the above consensus emerges from the empirical evidence, not through the tunnel vision of some theoretical constructs. In operationalizing this experience, a number of economic "lessons" must be kept in mind. The lessons are drawn from developing countries which differ not only in the details of their economic policies but also in their whole approach to growth and development. These differences have lasted not just a year or two but, in some cases, for decades. As a result, one of the major crosses our profession must bear, namely, that we cannot conduct controlled experiments, has been largely removed. Although the post-World War II experience is admittedly an imperfect substitute for controlled experiments, it does reveal that in economic development the facts speak loudly about the links between actions and consequences.

Serious inspection of postwar economic development suggests that (*a*) "getting the prices right" or "setting the property rights straight," or both, is not sufficient if an economy is to reach its full potential; (*b*) bad governments and institutions have been a serious, if not the most serious, obstacle to economic development in less-developed countries (LDCs); and (*c*) all public sectors pursue a mix of predatory and productive activities—bad governments emphasizing the former and good governments finding a way of promoting the latter. As Krueger (p. 19) has recently noted, successful developers have governments which "have been active in providing infrastructures—communication, transport, power, education, agricultural research, and extension—in support of economic growth. But, in almost all of the countries in which intervention, controls, and parastatal activities have been far reaching, these infrastructure investments have been sadly neglected." In terms of nuts and bolts, de Soto has shown that government regulations create serious roadblocks to economic participation. In many instances, cleverly disguised

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regulatory roadblocks provided significant deterrence to entry.[1] North has observed that, in much of the developing world, because governments play such an immense role in economic allocations and choices, the integration of political and economic theory is essential.

The Role of AID

In the above setting, what is the role or business of the Agency for International Development (AID)? As suggested in a recent report on the mandate of AID, a long list of concerns has engaged the agency's personnel and resources: humanitarian, political, national security, poverty alleviation, equity, economic growth, etc. (U.S. Agency for International Development). Evidence is provided that, increasingly, the role of the U.S. foreign aid program is limited either to smaller, strategically less significant countries or to playing the part of disbursement agent in strategically important countries. (For an analysis supporting this view, see Rausser 1989.)

In the face of the conflicting objectives for AID, there is some hope that this agency of the U.S. government, in fact, may be able to reduce strategic considerations in its outlay decisions over the next few decades. The signals justify the hope that economic growth-oriented development will no longer take a back seat to other U.S. objectives are fundamental. First, as noted earlier, ideological differences will be far less important over these next few decades than they have been since World War II. Moreover, if Hegel's view is correct, it is only a matter of time before liberal-democratic first principles are accepted by all LDCs. Second, the world itself has changed, both with the United States playing a relatively less dominant role on the world economic stage and with the potential for a new rapprochment with the Soviet Union. With these changes may come less concern about strategic alliances with developing countries.

It is to be hoped that the eideological battle that has existed in many LDCs over much of the post-World War II period is close to an end. However, regardless of how the trade-offs between economic and geopolitical or military goals unfold as the world role of the United States changes, AID should be able to focus more easily on providing support for achieving self-sustaining economic growth and development. In reviewing the potential effectiveness of AID's programs in promoting sustainable economic growth, a few conclusions are inescapable: (*a*) policies that encourage competitive forces are key to attaining sustainable economic growth; (*b*) institutions play a crucial role in creating and maintaining growth-oriented policies, whether defining and improving the security of property rights, lowering the costs of transactions (organization, supervision, coordination, monitoring, metering, etc.), or enhancing enforcement through an improved judicial system; and (*c*) policies and programs supported by international development agencies often place heavy emphasis on prescriptions from macroeconomic paradigms and fail to consider institutional bottlenecks and political constraints to implementing these prescriptions.

Given the expertise and charters of the World Bank and the International Monetary Fund and the comparative advantage of other bilateral donors, the niche where AID can be the most effective may be in the development of new institutions, institutional change, and the political economy of policy reform. These activities are labor intensive and require long-term commitments. The "mission infrastructure" of AID is well suited to perform the needed tasks. At the core of these tasks is a serious investigation of constitutional economics in each country.

The basic questions that pertain to such analysis are of the following types: Is the constitutional order of the country conducive to free inquiry and social experimentation or is it fundamentally repressive? Does the constitutional order provide ease of entry into the economic system, the political system, and ease with which the legal foundations of new institutions can be established? Does the constitutional order provide sufficient self-correcting mechanisms to limit excessive predatory governmental behavior? Does the constitutional order motivate agreement on basic values and processes for conflict resolution—a sense of civil order—to reduce the cost or risk of innovation?

Along with such fundamental constitutional issues, the basic political economic questions that must be analyzed include: What are the constraints and obstacles to economic growth that directly result from the power of interest groups? Who wins and who loses from current or reformed policies? What is the sustainability of

[1] To demonstrate this problem, de Soto tried to open a clothing business in Peru, legally and without paying bribes along the way. It took a lawyer and 3 other people a total of 300 days, or 1,200 man days, to complete all the necessary forms and to obtain all the signatures that were needed to start a business. As a comparison, de Soto performed the same task in Florida. Here, it took only 3 hours to start a new business. Peru is not unique.

the institutions and policies that support the status quo? What are the economic policy reforms that will promote economic efficiency and counter the constraints and obstacles that currently exist? What mechanisms or approaches can be utilized to obtain political consensus for the implementation of the proposed reforms? Does compensation make sense for those groups that are harmed by the adjustments that emerge after the policy reforms are implemented? With the implementation of growth-promoting policy reforms, are there public goods that might be offered to improve social services (e.g., health, population, education, etc.) that would ease the pain of adjustment resulting from the policy reforms? How can the interests of those groups which will benefit from reforms be appropriately articulated and channeled? What institutional changes are required for the reform policies to be sustainable? Do these institutional changes effectively alter the level and distribution of political power within the country?[2]

Alternative Paradigms

Over the years, a number of paradigms have been advanced for economic development (Bardhan). But very few, if any, paradigms exist which structure internally consistent analytical frameworks for policy reform. For the determination of government policy, two extreme perspectives within the economics profession have emerged over the years. The first is the public choice perspective, which focuses on the allocation of public resources in the political market, emphasizing redistribution to powerful interest groups (Downs, Buchanan and Tullock, Olsen, Becker). This literature quite naturally has led to analysis of rent-seeking and directly unproductive activities (Tullock, Bhagwati) which generate predatory behavior or "government failure." In this paradigm, interest groups play the role of the proverbial 800-pound gorilla—they go where they want, they sit where they want, and they take what they want. In essence, this paradigm is limited by its profoundly cynical view of the political process.

The predatory government perspective may, in fact, be an overreaction to the harm done by the paradigm at the other end of the spectrum (namely, the conventional welfare economics framework), where the state is a benign instrument for serving the public interest. As Stiglitz has emphasized, market failures abound in LDCs, and it would indeed be fortuitous if a benign instrument such as government intervention could be found for solving these pervasive failures. The market failures emanate from a number of different sources: unclear and insecure property rights, significant externalities, imperfect competition, informational imperfections, myopia, irreversibilities, sufficient need for and maldistribution of public and mixed goods, etc. Considerable empirical evidence supports a deeply skeptical view about the existence of a benign state to solve such problems anywhere in the world.

The conventional welfare economics paradigm presumes that "first-best outcomes" are achievable. The poor performance of many third world countries argues against the achievability of first-best outcomes. Neoclassical economic theory, on which the conventional welfare economics paradigm is based, cannot account for such performance. Moreover, as North (p. 32) notes, this theory "simply assumes away all the relevant issues."

Throughout the developing world, the public sector is not the perfect benign instrument envisaged by conventional welfare economics. But neither is it the manifestation of powerful interest groups concerned only with their well-being. In the conventional welfare economics paradigm, all political power resides in the hands of a benign government that attempts to correct whatever market failures might exist. In the new political economy paradigm, all political power resides with interest groups, and whatever actions are taken by the public sector can be characterized as predatory. Both of these paradigms represent extremes on a continuum. Either of them will make incorrect inferences of how policy outcomes are generated and thus should not be used in isolation to assess and evaluate reforms.

Governments do more than either engage in the improvement of allocative efficiency through collective action or simply serve rent seekers and the politically powerful. Accordingly, an alter-

[2] In this discussion, the implied dichotomy or separation between institutional change and the political economy of reform is made for convenience only. These two components of the development process are not separable. Bad policies will, over time, fundamentally corrupt and distort institutional performance. As most would agree, by initializing the movement to more innovative and competitive economies, policy reform and structural adjustment are essential to the process of institutional change in economic development. As the work of Ruttan and his associates has shown empirically on numerous occasions, market signals can induce institutional change. To the extent that these signals are severely distorted through predatory government behavior, institutional change can be expected to be misdirected.

native paradigm is needed that recognizes that power is distributed between the various interest groups and government and that maldistribution of power can blunt any and all efforts at economic policy reform. Moreover, this paradigm must recognize that governments can have some separate autonomy and can seek "leadership surplus" (Froelich, Oppenheimer, and Young).[3] What is needed is an internally consistent framework which admits the possibility and necessity of accommodating various interests. An appropriate political economic model is needed to conceptualize the bargains, pacts, compromises, and efforts that are undertaken to shape policies acceptable not only to those that have the greatest capacity to obstruct the process but also to others who stand to benefit from the policies.

Effective governments pursue productive activities while engaging in predatory pursuits for political-economic reasons. Specifically, predatory policies can compensate those groups and individuals that have sufficient political power to limit or obstruct efficient policies which lower transaction costs in the private sector. What is needed is an integrated framework that recognizes the joint determination of both predatory and productive governmental interventions. This framework must admit the political economy perspective of public choice theorists (all predatory, no productive activities) and the conventional welfare economics perspective (all productive, no predatory activities) as two special cases. In this new paradigm, institutions play a central role.

Variations in transaction costs and political power and influence mean that it must be possible to customize the new paradigm for the culture and customs of each country. In the proposed paradigm, current policies are viewed as a rational outcome of a political economic process. This political-economic process is one where the public sector can be viewed as a "central coordinator." A hierarchy structures the relationships between the authoritative center and the subordinate peripheral participants. The decision agents constituting the center are not oblivious to their own material well-being, social status, political power, etc. As a result, the center in this organizational setting is exposed to attempts by various interest groups to exert influence. In this framework, it has been shown, using a game-theoretic formulation (Zusman and Rausser), that if all power does not reside at the "center" and participants are in a position to reward or penalize the leadership, organizational failures naturally arise.

To illustrate this proposition, consider the classic case of regulatory organizations that attempt to manage the "tragedy of the commons" problem. Our results show that, while the center may fully internalize the common group interest, various self-interested participants who are accordingly narrowly rational in their attempts to influence can generate an organizational equilibrium that is suboptimal. Nevertheless, the establishment of this regulatory body will lead to a result that is superior to the pure predatory outcome but worse than the purely productive outcome. In essence, to the extent that the decision center internalizes at least part of the overall social interest, collective action improves upon the market-determined solution.

In this paradigm, good governments realize that their actions result in burden and gain sharing which may be unequally dispersed, that political power is unequal, and that because of limited information it is not possible to identify a priori the creative innovators or sectors that will prove to be the engines of growth from those that will not. Good governments also recognize the critical importance of "credibility." Would food riots have occurred in Egypt or bus fare and energy price riots in Venezuela if either of those two governments had had credibility? Did the South Korean government have more or less credibility when AID was actively involved in the structuring of that country's economic policies? A similar question may be asked today of Honduras and Egypt. Recent advances in game theory applications have shown the importance of the role of precommitments to government credibility. Properly designed precommitments for which it is impossible to reverse course have been shown to lead to intertemporal policy consistency. Credibility of commitments is indeed crucial to the implementation of significant reforms.

In the context of public policy reform, the mixed productivity/predatory paradigm offers a number of insights and refutable implications. Review of the history of major reforms in public policy throughout the world, whether developed or developing, shows that reform is motivated

[3] In the Froelich, Oppenheimer, and Young framework, leaders compete with other potential leaders for ascendancy and, once in office, maximize their surplus or profit by providing collective goods against taxes, donations, or purchases promised in the election process.

by one or more of the following events or forces: a major change (usually a precipitous deterioration) in the economic environment, a creative new design in implementation of policy mixes and/or compensation schemes, and/or the emergence of new political factions or major institutional changes.

A major change in the economic environment (e.g., the first 1980s oil crisis in Indonesia; the 1986–89 economic crisis in Poland, the Soviet Union, and East Germany; and the 1985 hyperinflation in Bolivia) shifts the possibility frontiers and leads to new mixes of productive and predatory policies. The design and implementation of new policy mixes and compensation schemes can alter the obstructionist behavior of various interest groups and their resultant deadweight cost in any rational collection of policies. South Korea's public policies are a wonderful illustrative example. The design and implementation of compensation schemes in Canada in response to the free-trade agreement with the United States is also illustrative. Developing better compensation schemes may be thought of as finding improved means to negotiate the allocation of society's welfare. In the search for reforms that augment the total size of a country's economic pie, predatory compensation schemes may be necessary. One of the political economic costs of implementing growth-promoting reform policies may be that associated predatory compensations must be made available to obstructionist interest groups.

Finally, major organizational and institutional changes can cover the full gamut: law and order, property law and property rights, contract law, laws governing exchange, the provision of public goods, conflict of interest, etc. At the core of any sustainable policy reform is the underlying constitutional framework. Changes in the relative benefits and costs of organizing those who would benefit are also major means of generating sustained reforms. Increasing the responsiveness of beneficiary groups to changes in their welfare allows the public sector to move in the direction of less wasteful combinations of productive and predatory policies.

Unless the "governing" criterion function that rationalizes the mix of predatory and productive policies is changed, unsustainable alterations in policy should not be termed "reforms" at all (Rausser 1982, Rausser and Foster, this issue). To move from a current mix of policies to sustainable reforms entails the movement from one policy equilibrium to another. This movement can be sustained through the emergence of new hierarchies and markets. In fact, one major market is the market for reform itself.[4]

Concluding Remarks

Throughout the developing world, the integration of political and economic forces is essential in understanding and prescribing roles for the public sector in order to achieve economic reform. Critical to this integration is an appreciation of the microforces within organizations and the central role played by transaction costs in any paradigm designed to explain current policy or prescribe policy reform. In the economics profession, there is a growing appreciation of these basic propositions. To the extent that public policies lower transaction costs in the private sector, collective behavior of the government pursues productive political economic interventions, expanding the size of the country's economic pie. To the extent that public policies serve powerful interest groups through predatory political economic schemes, portions of the country's economic pie are reallocated with varying degrees of waste. What has not been recognized in previous paradigms but is formally admitted by the paradigm suggested here is that these types of policies go hand in hand; frequently, predatory policies are offered as compensation to those that are harmed as a result of implementation of productive policies. Hence, predatory behavior becomes one of the political economic costs that must be borne when implementing growth-promoting policies, especially those that reform existing policies in effect to serve influential interest groups.

The integrated productive and predatory framework outlined in this paper not only offers an explanatory hypothesis for differing political economic equilibriums but also provides the basis for operational prescription. This prescription facilitates the search for a more equitable solution to public problems, the search for basic consensus on the nature of the public interest, and the creation of public trust based on a shared

[4] It should be kept in mind that the demand for reform can be realized most easily through constitutional-democratic processes which can reward or penalize officials or governments for the overall performance of their economic policies. The Hobson's-choice alternative is authoritarianism which, although it can sustain good economic policies by turning a deaf ear to protests, can also repress the demand for reform. The latter outcome is by far the most frequent among authoritarian governments.

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sense of legitimate authority. The framework explicitly recognizes the task for public policy economists emphasized by Aaron in his Richard T. Ely lecture at last year's AEA meetings (p. 13), "to identify policy rules that are robust and are important not only economically but, in a fundamental sense, politically."

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