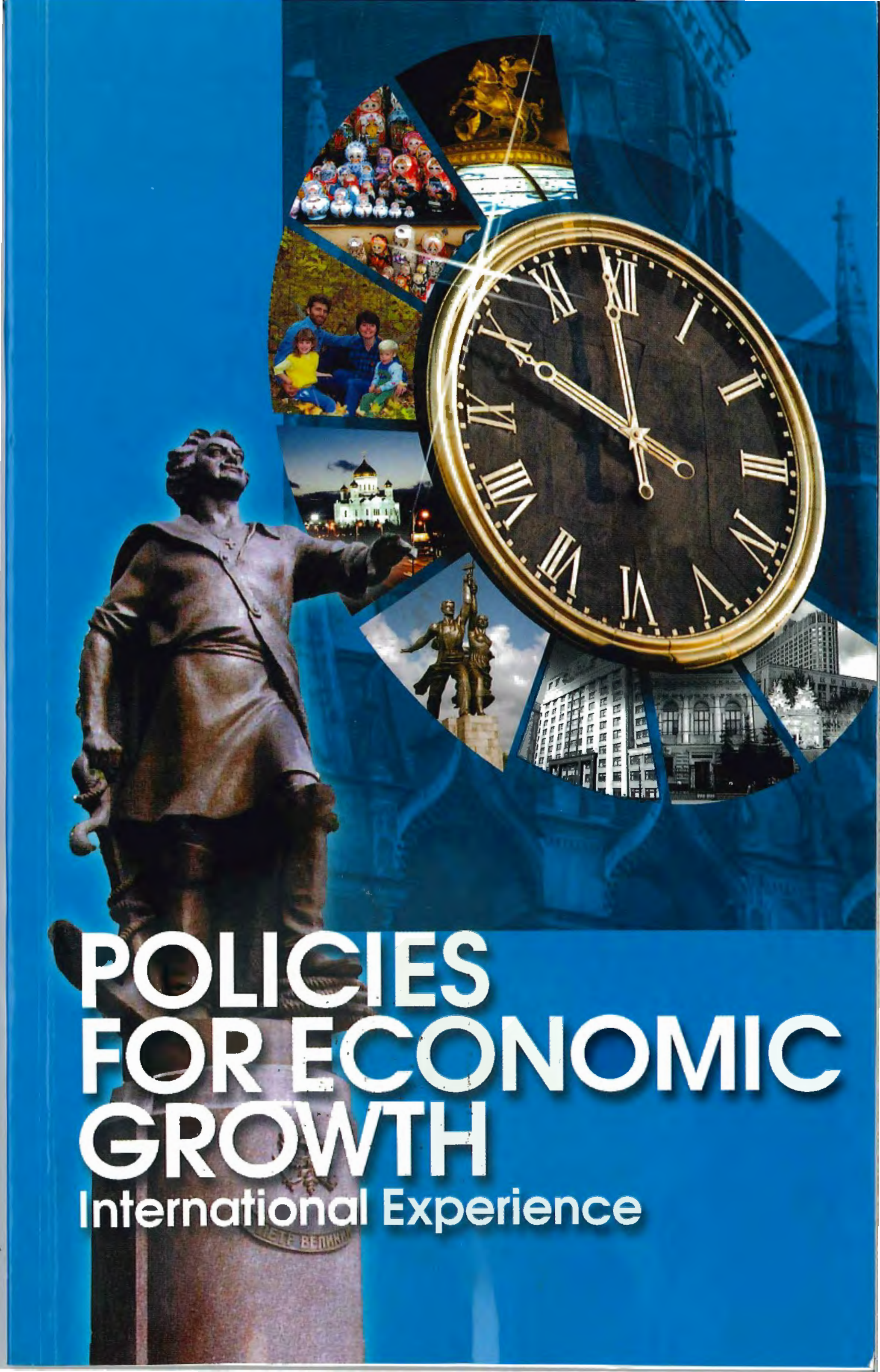

POLICIES FOR ECONOMIC GROWTH

International Experience

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Moscow
2001

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Р80 **A. C. Harberger, J. D. Gwartney, R. K. Vedder, R. Douglas, G. C. Scott, C. A. Bologna Behr, L. J. Kotlikoff, J. E. Carter**
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FOREWORD

The collection of policy papers contained in this publication were first presented in Moscow to the Russian public and the economic community in April 2000. The authors of these policy papers are all leading international economists and policy makers who were invited to Moscow to share their experiences and expertise with Russian analysts working on economic policy issues at the Center for Strategic Research (CSR). The CSR is a non-governmental institution, comprised of representatives from various Russian Think Tanks. It was created in December 1999 at the initiative of then Acting President Vladimir Putin.

The papers presented here reflect various aspects of the high-level policy dialogue that is taking place in Russia today. This dialogue presents a unique opportunity to inform the public discussion with respect to economic policy. This dialogue will also help stimulate a closer link between economic thinkers and policy-making officials.

On the following page please find a brief biography of each of economist featured in this publication.

July 2001

ECONOMISTS' BIOGRAPHIES:

Arnold C. Harberger — Professor of Economics at the University of California Los Angeles (UCLA) since 1984; Professor Emeritus at the University of Chicago since 1991. Professor Harberger has served as a consultant to numerous foreign governments, U.S. government agencies, international agencies and foundations. He is author or co-author of nearly 200 journal articles, books and conference papers. Government leaders from over 15 countries have called upon Professor Harberger's expertise. With a reputation as a hands-on practitioner of economics, he has also held consulting positions with global organizations, including the International Monetary Fund, the Asian Development Bank and the Organization of American States.

Currently a professor of economics at UCLA, Professor Harberger spent 38 years at the University of Chicago, where his research contributions were mainly in the fields of public finance, cost-benefit analysis, international economics, the economics of inflation and economic policy for developing countries. Numbered among his students at the University of Chicago and the UCLA are at least a dozen central bank presidents and two dozen foreign government ministers. However, Professor Harberger may best be known for his leadership of a group of economists from the University of Chicago who were significant free-market reformers in Chile during the 1970s.

James D. Gwartney — Chief Economist of the Joint Economic Committee, U.S. Congress, and Professor of Economics and Policy Studies at the DeVoe Moore Center for the Study of Critical Issues in Economic Policy, Florida State University. James Gwartney is an expert on economic issues such as taxation, labor policy, and the economic analysis of government regulation. Dr. Gwartney has testified on economic policy before various congressional committees. He has traveled extensively throughout Europe, the former Soviet Union, China and Latin America. Dr. Gwartney is co-author of *Economics: Private and Public Choice*, *"Economic Freedom of the World"* and *"What Everyone Should Know About Economics and Prosperity"*. He has also published several articles in the leading journals of professional economics, and in many newspapers including the New York Times and The Wall Street Journal.

Richard Kent Vedder is a Professor of Economics and a Faculty Associate of the Contemporary History Institute at Ohio University. Professor Vedder specializes in twentieth century American history (particularly labor history) and public policy issues, including intergovernmental fiscal relations. In addition to visiting appointments at various U.S. universities, Professor Vedder has served as a Senior Economist to the U.S. Joint Economic Committee. Professor Vedder is a co-author of *American Economy in Historical Perspective, Poverty, Income Distribution, the Family and Public Policy*, and *Out of Work: Unemployment and Government in Twentieth-Century America*. Professor Vedder's articles and reviews have appeared in numerous scholarly journals as well as such publications as the Wall Street Journal, National Review, Washington Times, and Investor's Business Daily.

Sir Roger Douglas served as New Zealand's Finance Minister from 1984 to 1988 where he earned an international reputation as the driving force behind New Zealand's economic reform. His tenure as Finance Minster saw major deregulation of New Zealand's financial markets, the floating of the New Zealand dollar, the adoption of privatization policies, and dramatic reforms of the tax system. Since 1990, Sir Douglas has been the Managing Director of Roger Douglas Associates, an international consulting firm, specializing in economic restructuring and structural adjustment issues. He has done considerable work in countries such as Brazil, Hungary, Canada, USA, Russia, Pakistan, Mexico, Austria, Fuji, the Philippines, Vietnam, Australia, China, Hong Kong, Singapore, the Netherlands, England and Peru.

Graham Cecil Scott served as the Secretary of the Treasury for the Government of New Zealand from 1986 till 1993. During this period Dr. Scott oversaw the implementation of new fiscal policy and public management approaches that revolutionized the way the New Zealand government manages its financial affairs. Since 1993, Dr. Scott has served as advisor to federal governments worldwide (Canada, Bangladesh, Mongolia, Thailand, Jamaica, Singapore, Colombia, USA, Indonesia, Trinidad, China, Malaysia, Fiji, Australia, Russia) on various aspects of public sector reform, including budgetary policy, public administration and management. His expertise also includes restructuring of natural monopolies, health sector reform and pension system reform. Dr. Scott holds a Ph.D. in Economics from Duke University and currently serves as an Executive Chairman of Southern Cross International Ltd., a company specializing in public sector reform.

Carlos Alberto Bologna Behr — President, San Ignacio de Loyola University, and former Minister of Finance (1991—1993) for the Government of Peru. As the former Peruvian Minister of Finance, Dr. Bologna was responsible for economic reforms implemented under the Fujimori administration. He has served as an adviser for World Bank, the Andean Pact and Economic System for Latin America (SELA). In 1993, Dr. Bologna founded the Institute of Economics of Free Market. Dr. Bologna currently is member of the Board of Directors of several large Peruvian firms. Dr. Bologna holds a Ph.D. degree in Economics from Oxford University.

Laurence J. Kotlikoff is a Professor of Economics at Boston University. In 1981-1982, Professor Kotlikoff served as Senior Economist for President Reagan's Council of Economic Advisors. Professor Kotlikoff has also served as a consultant to the IMF, the Wold Bank, the Harvard Institute for International Development, the Swedish Ministry of Finance, the Norwegian Ministry of Finance, the Bank of Italy, the Bank of Japan, the Government of Bolivia, the Government of Bulgaria, the Treasury of New Zealand, the U.S. Department of Labor, and other U.S. agencies and major U.S. corporations. Professor Kotlikoff has provided expert testimony on numerous occasions to various Congressional Committees. He is a co-author of "*Macroeconomics: An Integrated Approach*", author of "*Generational Accounting, What Determines Savings?*", co-author of "*Dynamic Fiscal Policy*", co-author of "*Pensions in the American Economy*", and co-author of "*The Wage Carrot and the Pension Stick*", and has published extensively in professional journals, newspapers, and magazines on issues of deficits, generational accounting, tax structure, social security, and insurance.

James E. Carter is an Associate Director of the National Economic Council at the White House (Office of Policy Development, Executive Office of the President of the United States). Mr. Carter has also served as an economic advisor to the Congressional Joint Economic Committee, and the Republican National Committee. As such, Mr. Carter developed and promoted legislative initiatives, cultivated and managed policy coalitions, drafted policy studies, opinion essays, and official statements. In addition, Mr. Carter has published numerous articles in USA Today, Investor's Business Daily and The Journal of Commerce on topics such as tax policy, federal budget policies, reform opportunities for federal programs. Mr. Carter holds an M.A. in Public Administration from George Mason University, and has his B.S. in Political Science from Northeast Missouri State University.

THE ROAD TO ECONOMIC RECOVERY: STRATEGIC ISSUES AND CHOICES

Arnold C. Harberger

University of California, Los Angeles
August 2000

(Aide-Memoire on conversations and seminars held during a visit to Moscow in May, 2000, sponsored by the USAID Mission in Russia and organized by Development Alternatives, Inc.)

Any paper of this type must appropriately begin with a disclaimer. Our visit was organized with the objective of bringing to Russia the insights of individuals with wide experience in other parts of the world. Its aim was to explore the ways in which that experience might usefully be brought to bear on the severe problems currently facing the Russian economy. This aim poses severe constraints on those like myself who try to draw useful lessons from the experience of other countries. These constraints quite obviously stem from the many aspects of Russia's current situation that have little or no counterpart in the economies where we gained our experience. These many special features of the Russian case should warn us to proceed with caution as we attempt to draw lessons from the experience of other countries. I have been fully aware of this need for caution as I have conducted my search for relevant lessons. This helps account for my concentration in the present document on the most basic and fundamental economic forces — forces whose operation does not depend in any serious way on specific institutional and historical features. It must be said, however, that I am thinking throughout in terms of economies in which market forces play a fundamental role in determining the allocation of resources.

Keeping Inflation Under Control

When an economy is in a depressed, uncoordinated state, one seeks ways of stimulating production in a manner that is: a) *economically efficient* now and b) likely to continue to be efficient for some time as the economy evolves.

The worst way to attack the problem of a depressed economy is through large doses of inflationary finance. Not only does inflation represent a highly inequitable tax on those who happen to have incomes or assets that are fixed in nominal terms (or that adjust very inadequately in response to inflation); in addition, and very importantly, ongoing serious inflation introduces *significant distortions* into the economy, and impedes key elements in the process of economic growth.

Many economic texts treat inflation as if it were a simple, straightforward tax on real cash balances. No one can deny that inflation entails such a tax, because the cash balances one is holding are continually losing value as the price level rises. The textbook treatments, however, *make a big mistake* in ignoring the other costs of inflation, which far outweigh the costs of a tax on real cash balances.

These other costs consist first of time, energy and resources that people spend in protecting themselves from inflation (even sometimes in trying to profit from inflation); second in the ways in which the inflation process blurs the signals that a well-functioning price system is supposed to provide, and third in the likely negative impact of inflation on the rate of investment in the affected economy.

The blurring of price signals is a point that merits elaboration. Prices play a critical role in an economic system based on market principles. If a good is in short supply (relative to its demand at the prevailing price), its price will tend to rise, thus stimulating additional supply. Resources are thus attracted (by higher prices) to activities where demand has increased. The price signals work in the opposite direction for activities facing a declining trend of demand.

Obviously, it is the ***relative***, not the absolute prices of goods and services that are relevant for this signaling function of the price system. The trouble with inflation is that economic agents cannot readily distinguish between price rises that are simply the consequence of inflation (and hence do not call for a reshuffling of the resources of the economy) and those that are genuine *signals* for resources to move. The problem would be bad enough even if actual price movements could be neatly broken down into an inflationary component (the same for all prices) plus a relative price component, serving as a signal for resource allocation; because ordinarily demanders and suppliers would have a hard time perceiving the size of inflation component at any given point in time. It is much worse than that *in the real world*, because even though in the end inflation tends to affect all prices equally, it does so at vastly different speeds. Some prices, particularly those of primary products, exhibit a rapid response to inflationary forces, while others (like rents and public utility rates) tend to respond quite sluggishly. Thus, even if no fundamental changes in the underlying real economic equilibrium are taking place, one will see some prices (A) move more rapidly than others (B) in the early phases of an inflationary process, thus seeming to signal a call for resources to move from B to A. Then, in the latter phases of the same inflationary process the second set of prices B will rise more rapidly, as they finally come to fully "digest" the inflation in question.

Thus it is that an inflation process actually sends relative price signals to economic agents — but they are false signals arising simply from different speeds of a responsiveness of different prices as more fuel is injected into the engine of inflation. So now, the economy's suppliers and demanders have a huge problem. It is not just distinguishing a common inflationary component of price changes from individual relative price movements. Instead they have relative price movements arising out of the inflationary process itself, plus relative price movements that are genuine longer-term signals. It is the uncertainty about what is signal and what is noise that creates these additional problems — problems that grow in size and importance as the rate of inflation increases.

The greater is the rate of inflation, the greater is the confusion that besets economic agents as they try to discern what are the genuine signals that the economy is sending them. Two consequences follow quite naturally. First, agents will be more reluctant to respond to apparent signals (observed changes in relative prices), the greater is the ongoing state of inflation. So the economic machine will react to real changes in supply and demand, but more sluggishly. Second, agents will make more mistakes, the higher is the rate of inflation. The more noise there is, relative to signal, the greater the likelihood that people will be reacting to just noise, thinking that it is a signal. In this way economic agents end up taking actions that have a negative economic effect, by misinterpreting the meaning of the relative price changes they observe.

The blurring of relative price perceptions that appear with high rates of inflation has a direct effect on the rate of economic growth. As is well known, and as I will emphasize later, the discovery of ways of reducing real costs is a very important component of the growth process. With blurred perceptions, economic agents find it harder to identify possibilities for real cost reduction. What looks like a genuine cost-reducing opportunity today may disappear or even end up by raising costs, as the prices of inputs and outputs weave their separate paths of adjustment to inflation.

Inflation also tends to hurt growth by diverting resources from investment in the economy in question. The uncertainties connected with inflation are very likely to raise the threshold real rate of return, which people require before they will willingly invest. At the same time, inflation at home makes people more interested in placing their savings abroad, or if not abroad, in accumulations of dollars or pounds or DM or francs that they keep within easy reach. Needless to say, these various ways of diverting funds from investment in the local economy have the effect of reducing the rate of growth.

Many empirical studies have documented the negative impact of inflation on growth. So I am not here going to try to repeat their demonstration or re-examine their evidence. I will, however, report on two empirical exercises, which may be helpful to present or future policymakers.

One has heard many times the familiar refrain that reducing the rate of inflation entails "high social costs". It is widely believed that a serious recession, even maybe a depression, is the price that a country has to pay to get itself out of an inflationary orbit. Table 1 presents very clear evidence that this is ***not*** the case.

The cases examined in *Table 1* all fall into a category that I call "acute inflation", where inflation rises close to 100% (I used a cutoff rate of 90%) or more at its peak, before a stabilization process is mounted. *Table 1* identifies the period in which inflation is rising to its peak and the subsequent period in which the rate of inflation is falling, and then shows the annual average growth rates of GDP during these respective periods. It is notable that the rate of GDP growth in the period of declining inflation is, in all but two cases (both for Brazil) greater than that for the period of rising inflation. And even in those two periods of declining inflation, Brazil had positive rates of GDP growth (0.86% and 2.68%, respectively).

Overall, the median rate of real GDP growth for the 21 periods of rising inflation was 0.42% per annum, while that of the 21 periods of declining inflation was 4.37% per annum — representing what must be described as a ***huge*** difference in growth rates.

Tables 2a, 2b, and 2c undertake a different empirical experiment. Instead of simply focusing on a single, big up-and-down inflationary episode, in these tables we follow a country through a substantial period of its history, correlating year-by-year rates of inflation with the corresponding contemporaneous growth rates of real GDP. These tables reveal an insight that we are well advised to remember — the negative connection between inflation and growth is strongest for countries which experienced what we have called acute inflation; it is less marked but nonetheless present for countries whose maximum annual rate of inflation was in the 20% to 90% range; and it is for all practical purposes absent for countries and periods where exchange rate stability (or something very close to it) prevailed.

It is worth while for us to consider the reasons for the very equivocal results that emerge when we correlate rates of inflation with rates of real growth for stable exchange rate countries. In the first place it is important to note that in these countries inflation is always kept within quite narrow bounds — it does not have the kinds of variation that are present for the other two categories (*Tables 2a and 2b*). But the forces that determine real growth rates (apart from inflation itself) operate with pretty much equal strength in these stable countries as they do in the other cases examined. Natural disasters and world recessions

Table 1

ACUTE INFLATION EPISODES

Country	Period	Annual Rate of Inflation			Annual Rate of Growth of Real GDP	
		Rising Inflation Period	Peak Rate Period	Declining Inflation Period	Rising Inflation Period	Declining Inflation Period
Mexico	1979–1987–1994	63.83	131.8	30.82	2.92 <	3.54
Argentina	1975–1976–1981	313.45	444.0	152.95	–0.49 <	1.20
Argentina	1982–1985–1987	382.39	670.1	110.71	–0.98 <	4.87
Argentina	1988–1989–1998	1711.20	3079.8	281.14	–4.41 <	5.07
Indonesia	1962–1966–1972	365.86	1136.3	45.60	1.22 <	7.26
Peru	1987–1990–1998	2908.30	7481.7	83.80	–3.93 <	5.39
Nicaragua	1985–1988–1996	4045.59	10205.0	503.07	–4.00 <	1.73
Israel	1978–1984–1998	145.22	873.8	36.88	2.64 <	4.53
Ghana	1976–1977–1980	86.2<7	116.5	59.20	–0.60 <	1.72
Ghana	1981–1983–1994	87.22	122.9	26.01	–2.73 <	4.52
Chile	1972–1974–1982	328.96	504.7	63.14	–4.80 <	3.90
Turkey	1977–1980–1983	60.31	110.2	32.94	0.42 <	4.47
Uganda	1984–1987–1991	151.50	200.0	40.88	3.13 <	6.17
Venezuela	1993–1996–1998	64.68	99.9	42.91	0.43 <	2.62
Costa Rica	1980–1982–1987	48.44	90.1	17.66	–2.91 <	4.37
Brazil	1978–1985–1986	116.20	226.9	147.14	3.55 <	7.00
Brazil	1987–1990–1991	1308.98	2937.8	432.78	2.05 >	0.86
Brazil	1992–1994–1995	1651.84	2668.5	22.97	3.35 >	2.68
Bolivia	1980–1985–1998	2251.58	11749.6	32.62	–1.50 <	3.49
Uruguay	1972–1973–1978	83.95	47.0	51.13	1.95 <	3.47
Zambia	1989–1993–1997	136.15	188.1	39.72	0.70 <	1.06

bring low or even negative growth rates, while export price booms and huge capital inflows bring positive growth rates. One has little reason to expect that these events will be strongly and negatively correlated with movements of the rate of inflation within its relatively narrow band.

Now with respect to the rate of inflation itself, its main movements (for a stable-exchange-rate country) are likely to come from two types of source. First, there are movements in the general world price level, measured in dollars or pounds, or whatever other currency the country's money may be pegged to. These world price movements will typically be reflected in the country's own

Table 2a

ACUTE INFLATION COUNTRIES*

(15 of 16 correlations are negative)

	Sample Period	Annual Rate of Growth of Real GDP		Annual Rate of Inflation		Coeff. of Correlation	Statistical Signficance		Maximum Inflation in Sample
		Average	Std. Dev.	Average	Std. Dev.		10 %	5 %	
Nicaragua	1973–1996	0.21	7.85	1148.22	2648.34	–0.30	*		10205.00
Bolivia	1961–1998	3.55	3.08	372.22	1907.38	–0.33	*	*	11749.64
Brazil	1964–1998	5.40	5.21	350.87	689.87	–0.22	*		2947.73
Peru	1951–1998	3.79	5.16	227.53	1171.85	–0.41	*	*	7481.66
Argentina	1952–1998	2.57	6.36	212.50	556.59	–0.31	*	*	3079.81
Uganda	1981–1996	5.60	3.61	71.64	68.50	–0.17			200.00
Indonesia	1959–1997	5.68	3.10	64.37	185.78	–0.30			1136.25
Chile	1961–1998	4.25	5.65	60.86	111.84	–0.49	*	*	504.73
Uruguay	1956–1998	2.00	3.82	51.89	29.58	0.11			125.34
Turkey	1967–1998	5.37	5.73	45.89	30.97	–0.42	*	*	110.17
Mexico	1976–1997	3.31	4.00	42.84	35.84	–0.53	*	*	131.83
Israel	1956–1996	6.14	4.16	41.90	76.15	–0.38	*	*	373.82
Ghana	1965–1997	2.62	5.03	35.42	32.63	–0.15			122.87
Zambia	1962–1997	2.39	6.13	34.78	46.25	–0.12			188.05
Venezuela	1958–1998	3.64	4.05	18.76	23.75	–0.40	*	*	99.88
Costa Rica	1971–1998	4.08	3.55	18.66	16.50	–0.79	*	*	90.12

* Countries in this sample had at least one year of 90% inflation or more; each sample period has been chosen as to not include a long period during which the exchange rate was fixed, if any existed.

Table 2b

INTERMEDIATE GROUP (DEVALUATION EPISODES*

(11 of 15 correlations are negative)

	Sample Period	Annual Rate of Growth of Real GDP		Annual Rate of Inflation		Coeff. of Correlation	Statistical Signficance		Maximum Inflation in Sample
		Average	Std. Dev.	Average	Std. Dev.		10 %	5 %	
Nicaragua	1974–1998	2.79	5.59	25.94	19.76	–0.07			72.81
Ecuador	1966–1998	5.57	6.14	23.52	18.79	–0.31			75.65
Dominican Rep.	1985–1997	3.78	4.31	22.51	19.19	–0.75	*	*	50.46
Colombia	1969–1996	4.55	1.91	21.84	6.35	–0.50	*	*	33.05
Paraguay	1984–1997	3.34	1.71	21.05	8.29	0.05			38.18
Jamaica	1961–1997	1.88	4.01	16.86	15.43	–0.37	*	*	77.30
Malawi	1969–1997	4.36	5.56	16.81	15.76	–0.09			83.33
Egypt	1983–1998	5.61	2.44	14.86	5.90	0.06			23.86
Madagascar	1965–1997	1.33	3.61	13.18	11.46	–0.21			49.06
Korea	1955–1997	7.69	3.74	12.41	11.76	–0.23			68.20
Syria	1961–1997	6.37	8.59	11.29	12.02	–0.17			59.48
Philippines	1960–1998	3.94	3.38	11.09	9.31	–0.51	*	*	50.34
Bangladesh	1974–1997	4.73	2.75	10.57	10.64	0.38			54.77
Pakistan	1972–1998	5.30	2.16	10.12	5.53	0.00			26.66
India	1966–1997	4.84	3.25	8.49	5.84	–0.04			28.60

* These countries have at least a 20% inflation rate in any year plus at least one devaluation crisis; the maximum annual inflation rate for each is less than 90%.

Table 2c

STABLE EXCHANGE RATE CAUNTRIES — LOW INFLATION EPISODES

(10 of 18 correlations are negative)

	Sample Period	Annual Rate of Growth of Real GDP		Annual Rate of Inflation		Coeff. of Correlation	Statistical Signficance		Maximum Inflation in Sample
		Average	Std. Dev.	Average	Std. Dev.		10 %	5 %	
Morocco	1985–1998	3.64	6.01	4.90	2.43	0.09			
Jordan	1990–1998	5.24	5.16	5.89	4.60	–0.46			
Singapore	1961–1997	8.53	3.82	3.17	4.81	0.07			
Thailand	1954–1996	7.20	3.13	4.98	5.25	–0.10			
Malaysia	1971–1997	7.51	3.02	4.45	3.49	0.25			
Panama	1951–1998	5.24	4.77	2.44	3.49	0.07			
Papua New Guinea	1975–1993	2.88	5.24	6.36	2.24	–0.33			
Kuwait	1973–1995	1.36	14.47	5.10	3.66	–0.53	*	*	
Syria	1988–1998	5.47	6.35	13.25	8.78	0.43			
Syria	1961–1987	6.70	9.37	10.56	13.09	–0.26			
Ethiopia	1997–1991	1.75	5.95	8.92	10.65	–0.67	*	*	
Paraguay	1959–1983	5.52	3.91	8.75	8.09	0.49	*	*	
El Salvador	1952–1985	3.50	4.27	5.99	7.14	–0.49	*	*	
Haiti	1967–1990	2.03	3.34	7.74	7.74	0.25			
Honduras	1951–1989	3.89	3.56	4.65	4.44	–0.16			
Dominican Rep.	1963–1984	5.61	5.28	7.32	6.07	0.16			
Guatemala	1952–1985	4.21	3.02	4.36	5.85	–0.07			
Mexico	1957–1975	67.07	1.918	5.97	5.83	–0.11			

* Sample periods correspond to years in which the country in question had a fixed exchange rate, or during which its exchange appreciated or depreciated very moderately, at a maximum average rate of 1.5% depreciation or appreciation per year.

price level, but quite unconnected to the forces governing its rate of real GDP growth. Additionally, one finds in fixed exchange rate countries a scenario that quite naturally conduces to a positive (rather than the "expected" negative) connection between the rate of price level change and the rate of real economic growth. This scenario is related to the real exchange rate, about which more will be said in the next section. Here we will simply note two important sources of an abundance of dollars — a) an export price boom and b) a large capital inflow. In both cases the abundance of dollars causes the dollar to be cheap in real terms. With a flexible exchange rate this could turn out to be simply reflected in a fall in the local currency price of the dollar. But with a fixed rate, the typical scenario is for the Central Bank to buy the dollars, creating base money in the process. Equilibrium is reached when the internal price level has risen enough to cause an increase in the demand for dollars (typically for imports) that is big enough to match the increased supply arising out of increased exports and/or capital flows. The presence of this mechanism for fixed exchange rate countries helps explain why nearly half the observed correlations between the inflation rate and the real GDP growth rate (though low) are positive. By contrast, for the acute inflation countries only one of the sixteen correlations is positive, and in the intermediate case only four out of fifteen correlations are positive.

The Role of the Real Exchange Rate

Let me begin this section by pointing out that, in the 1940s, 1950s and 1960s, even specialists in the field of international trade were unfamiliar with the concept of the real exchange rate. My own diagnosis is that its special role was obscured by the simplifications (assuming a world of two countries A and B, two products X and Y, and two factors of production L and K) that were typically employed in classrooms and in theoretical work obscured the need for such a concept. Moreover, the 1950s and 1960s were decades of relative calm, in which the real exchange rate did not come to center stage either as a reflection of new and critical problems, or as a policy variable that might help in their solution.

All this changed dramatically in the 1970s and 1980s. The first decade was characterized by two major oil price shocks, and by one major world recession, and also by the inevitable abandonment (in the face of these shocks) of the Bretton Woods system. All these elements led to an era of unprecedented volatility of real exchange rates. This volatility was a reflection of changes that were taking place in the underlying structure of supply and demand, to which the adjustment of a country's real exchange rate was typically a natural and necessary response. But at times the problem took the reverse form, of a disequilibrium whose solution (a major adjustment of the real exchange rate) was prevented or long delayed, usually by a combination of rigidities both of prices and of the nominal exchange rate.

By studying the experiences of countries in the 1970s, 1980s, and 1990s, we have come to have a quite full appreciation of the role that the real exchange rate plays in the economic system. That role is nothing less than its being the "fundamental equilibrating variable" of a country's balance of payments. All kinds of disturbances lead quite naturally to the need for an upward or downward adjustment in the real exchange rate:

a) reducing tariffs, quotas and other import restrictions leads to an increased demand for imports hence to a rise in the equilibrium real price of the dollar.

b) reducing restrictions on exports adds to the supply of foreign currency, hence to a fall in its equilibrium real price.

c) a boom in the world price of a major export commodity makes dollars abundant, so their real equilibrium price falls.

d) technical advances (real cost reductions) in the prices of tradable goods adds to the supply of exports and/or import substitutes. This adds to the supply of dollars (via more exports) or reduces the demand for them (via lower imports), with the result that the equilibrium real price of the dollar falls.

e) capital inflows typically add to the available supply of dollars, thus tending to reduce their equilibrium real price. One should note here, however, that the effect of a capital inflow on the real exchange rate will differ depending on how it is spent. If money is borrowed and used exclusively to buy capital equipment (or other tradable goods) for a new project, the new supply of foreign exchange is just matched by a new demand, so there is no effect on the equilibrium real price of the dollar. It is quite different if the borrowed money is spent on local (nontradable) goods and services; in this case the borrowed dollars have to be converted to local currency, creating a need for a fall in their equilibrium real price.

This list of forces affecting the equilibrium real exchange rate should give readers an appreciation that mastery of real exchange rate analysis does not come easily. Much misunderstanding of this subject has prevailed and continues to prevail. There is a great need for policymakers to recognize the fundamental importance of the real exchange rate in the ongoing processes of a modern economy, and also to bear in mind that it is a variable that responds to many different and complex forces. This is not an area where simplistic notions can serve as a reliable guide.

The real exchange rate has a particularly important place in the situation of Russia today. The Russian economy has been engaged in a major adjustment process for more than a decade, and still has not achieved the goal of a thriving market economy, with its resources fully and efficiently employed, and with its links to the world economy fully and efficiently developed.

The analogy fits quite well to think of the Russian economy as being in a swamp, struggling to get out to dry land, where it can move much better and much faster, and can operate much more productively.

How can the Russian economy escape from this swamp? It surely requires a healthy, economic demand for the services of its abundant human and physical resources. How can this demand be fostered, stimulated, developed? The easy response is to create demand internally, perhaps by the government, perhaps via the banking system. Such "autonomous" creation of demand invariably involves, in one form or another, the inflationary expansion of the money supply. This was the subject of the preceding section, where the folly of the inflationary path was amply demonstrated. High rates of inflation are, in theory, in practice, and in common sense, inimical to economic efficiency and to economic growth. And in the Russian case, one can also say that the inflationary "solution" has already been tried, and has led to disastrous consequences.

The alternative and much better avenue of escape from the swamp is provided by the real exchange rate. The objective in this case is export-led growth, in which the economy exploits its known sources of comparative advantage, and in the process also encounters new ones.

This route out of the swamp can be said to be the natural one, in the sense that it is likely to evolve quite naturally in a market economy. If a country has to export more to solve its problems, then what is more natural than for those exports to be priced attractively? And attractive pricing for exports means high prices in rubles, as far as Russian producers are concerned, and low prices in dollars, pounds or marks as far as foreign buyers are concerned. A high real price of the dollar accomplishes both of these apparently contradictory objectives at the same time.

A high ruble price of the dollar gives a strong incentive to old export items, and at the same time stimulates a search for new items of comparative advantage. It was the stimulus of a high real exchange rate that led to the development in Chile during the middle and late 1970s, of several major new export items — including salmon (in which Chile is now one of the three biggest exporters), kiwis (in which it disputes for leadership only with the old leader, New Zealand), and table grapes, peaches, raspberries, nectarines and other fruit. These are all items of true comparative advantage for Chile. The salmon are cultivated in the fiords of Chile's southern coast, just as they are cultivated in the fiords of Norway and Scotland. The boom in fruit exports is quite natural, too, as it takes advantage of Chile's location in the southern hemisphere and of its rich soil and benign climate.

Yet this comparative advantage remained unexploited for many, many years. Production and export of these new items was stimulated by a high real price of the dollar in the mid-1970s, which made it highly attractive for people to experiment with ideas for new export items. In every single case major investments were involved, which took years to bear fruit. Once again the high real exchange rate was a major contributor to the attractiveness of these investments.

Influencing the Real Exchange Rate

I hope that the preceding section has given readers a good appreciation of the importance of the real exchange rate as a key economic variable, and of the many different forces that are reflected in its movements. As is the case for most economic prices, it is a variable that should be treated with a great deal of respect — one should not dream of ordering it around, of telling it what to do. Here, as elsewhere on the economic stage, the law of supply and demand has to be appreciated and respected.

It is within this context that one ought to be thinking as one contemplates the role of the real exchange rate (RER) in economic policy. The RER cannot be ordered about, and cannot be simply manipulated to do what the policymaker wants. But this does not say that it cannot be ***influenced*** by the actions of the economic policy authorities.

There are two ways in which the authorities can fruitfully work to influence the RER. The first is by operating on the real variables that influences the supply and demand for foreign currency, and the second is by moving the nominal exchange rate to facilitate the adjustment of the real rate to a new equilibrium level. But one must shun like the plague any idea that one can sensibly think of using changes in the nominal exchange rate as an *instrument* for bringing about changes in the equilibrium level of the RER.

I now proceed to a series of historical examples, each of which illustrates one or another of the points just made. First will be the case of El Salvador 1985-88, which will show the futility of trying to use a nominal instrument (in this case the nominal exchange rate) as a device for changing the equilibrium value of a real variable (in this case the real exchange rate). The second is Brazil, 1968-1979 where a policy of targeting the real exchange rate succeeded in that objective. In this case real instruments were used, namely changing the intensity of import restrictions plus accumulating reserves of foreign currency. The third example is Chile, 1985-1998, where the real exchange rate was also targeted, but less strongly than in the earlier Brazilian case. Here the main real instruments were at the beginning the repatriation of foreign debts, and toward the end the massive accumulation of foreign reserves. The final example is that of contemporary Argentina, where the real exchange rate has been out of equilibrium for at least five years, and a tragic confluence of economic rigidities has frustrated its appropriate adjustment.

El Salvador, 1985-1988. The economy of El Salvador has for more than two decades been characterized by what is perceived as a low real price of the dollar. This perception is reflected in constant complaints by large numbers of producers of tradable goods. In my own experience there, the agricultural sector has been the most vocal complainer. Farmers have had a difficult time meeting international competition and, not being economists, have come to a simplistic determination of what was wrong. What they alleged was that the government, and in particular the Central Bank, had in its hands a very simple answer to their problem. Whereas they (the farmers) were barely surviving at the prevailing exchange rate, the whole sector could be made to thrive if only the exchange rate were, say, to be doubled. Misery would be turned into prosperity, losses into profits, penury into wealth. How, asked the farmers, could the authorities be so stupid as not to see and appreciate this?

Well, the authorities yielded and performed the experiment in early 1986. The exchange rate had been 2.50 colones per dollar for many years; now it was doubled to 5.00 colones. With this, according to the farmers' view, the agricultural and other producers of tradables goods should have been rescued from their plight. Undeniably a sort of temporary rescue did take place, but by 1988, barely two years after the massive devaluation, the general price level had doubted, compared to its pre-devaluation (1985) level. And by 1990 it had tripled. The dollar value of merchandise exports, which had averaged about $700 million in 1983-85, jumped to $777 million in 1986, but quickly receded to about $600 million in 1987 and 1988, and was below $600 million for the following three years.

What happened to frustrate the results that agriculturists and others so fondly expected from a massive devaluation? The answer is that the ***underlying real situation of the economy had not changed***, and in particular the devaluation did nothing to change the equilibrium value of the real exchange rate.

The reason why the real exchange rate was low in El Salvador in the middle and late 1980s, and continues low to this day, is the massive flood of dollars that arrives every year in the form of emigrant remittances and foreign aid. These have financed the bulk of El Salvador's excess of imports and exports for more than 15 years — deficits that have ranged from 6 to 15 percent of GDP in the period in question. This flood of dollars is what made the dollar abundant and therefore cheap in real terms. I have often said to complaining farmers in El Salvador, if you really want to raise the real price of the dollar, tell your relatives and friends in Los Angeles to stop sending remittances, and tell your government to stop accepting foreign aid. Cut off these sources of supply of dollars and the price of the dollar will surely rise in real terms. But as long as these inflows of dollars continue, you can expect the dollar to be cheap.

Needless to say, my argument here was rhetorical. El Salvador as a nation and a society has clearly benefited both from emigrant remittances and from foreign aid. It is not in their interest to cut off either flow. My real point is that while these large inflows of dollars continue, the equilibrium real exchange rate will remain low. A major devaluation will change the nominal rate, but the real rate will try to go back to its equilibrium level, as it actually did in the period 1986-88. In the end, all that El Salvador got out of its big devaluation of 1986 was a roughly doubled price level.

Brazil, 1968-1978. Brazil's economy was in a state of distress in 1963-64, beset by high levels of protectionism, inflation, price controls and related maladies. A series of major reforms in the 1964-68 period set the stage for the so-called Brazilian miracle of 1968-78. One of the key policies characterizing that "miracle" period was the attempt to maintain the real exchange rate at a level that would stimulate investment in the production of tradable goods in general, and of export goods in particular.

If the El Salvador episode demonstrates that one cannot successfully target the real exchange rate using a nominal instrument, the Brazilian miracle period shows that one can at least sometimes succeed in such an attempt if one uses one or more real policy instruments. The key real instruments were a buildup of foreign exchange reserves plus the manipulation of import restrictions so as to influence the market's demand for foreign exchange. Brazil started this period (Dec., 1967) with only $157 million of foreign currency reserves, and ended it (Dec., 1978) with over $11 billion. The buildup of reserves actually came in two spurts — one which lasted until 1973 and brought reserves to $6.36 billion, and a second in which they rose from $3.65 billion at the end of 1975 to $11.83 billion at the end of 1978. In between, reserves were depleted in response to the 1974 oil crisis, but this too was in pursuit of Brazil's RER target. For the two periods when reserves grew, the market would otherwise have set a rate below the target, so purchases were called for. During the oil crisis years, however, market demand for dollars soared, and it took sales of reserves to keep the RER from exceeding its target level.

The other instrument Brazil employed was changes in import restrictions. During the first period this was a case of happy coincidence as between two policy objectives. The government wanted to liberalize trade, and was faced with existing import barriers that were far too high. Lowering these barriers helped it to meet its liberalization objective, and at the same time the added demand for foreign currency helped lift the real exchange rate to the target level. Brazil's strategy during the 1968-73 period can be thought of as turning first to reserve accumulation as the "central variable" to influence the RER. But then, if the required rate of reserves accumulation was too great, a judicious reduction of import restrictions was brought into play.

One can think of this strategy as being put into reverse gear starting with the oil price boom of 1974. Recall that now the market pressure was toward a real exchange rate that was higher than the target. Brazil first sold off its reserves, but when they were judged to have fallen too far, the Brazilian authorities responded by putting an additional import restrictions so as to curtail the demand for dollars and bring the equilibrium RER down to the target level they had set.

Most economists genuinely applauded as import restrictions were successively reduced or eliminated during the 1968-73 period, but were dismayed by the reintroduction of such restrictions in the 1974-78 period. It must be said, however, that this policy, though far from being first best, did in fact succeed in holding the real exchange rate to within plus or minus 5% of its target level, all the way through 1978. Moreover, the growth of the Brazilian economy was spectacular, averaging 10% during 1968-73, and 7% during 1974-78.

Chile, 1985-98. Chile was the Latin American country that was hardest hit by the debt crisis of 1981-82. The capital inflow into that country had reached a peak of 15% of GDP in 1981 (which was higher than the peak attained by any other Latin American country), and fell by more than 10 percentage points of GDP in the single year 1981-82. However, this turnaround happened to coincide with a precipitous fall in the price of copper, which fell by more than 30% between 1980 and 1982.

The Chilean economy remained in a deep depression until 1985, when a new finance minister (Hernan Buchi) and a new economic team mounted a series of major new economic reforms. These represented a continuation of the process of liberalization and modernization that had characterized the earlier Chilean boom of 1975-81. The cornerstone of Buchi's macroeconomic policy was the real exchange rate. His objective was to emulate the Brazilian miracle by organizing an economic recovery that was driven by the growth of exports. A high real price of the dollar was sought as a means of stimulating this export growth.

The real instruments that Buchi employed to influence the real exchange rate included trade liberalization and accumulation of international reserves (both familiar instruments from the Brazilian and the earlier Chilean (1975-81) episodes), plus what I will call "Buchi's secret weapon". This was the repatriation of private sector debt, carried over from the big capital inflows that had characterized the years 1979-81. It was mainly owed by Chilean banks to banks in the U.S. and Europe. In the wake of the debt crisis there had emerged in New York a secondary market for Latin American debt of all kinds, in which the debt instruments were transacted at varying degrees of discount below par. At the time Buchi discovered his secret weapon, the debt instruments of the main Chilean debtor banks were transacting at about 60% of par.

It was not legal for the Chilean banks to go into the international market to repurchase their own bonds at discounted prices. But that did not deter others from performing the same function. The Chilean authorities became alerted to the situation when the Central Bank began to receive large and growing demands for dollars, for the purpose of buying and repatriating the discounted bonds of Chilean banks. Fearful that such applications would lead to unmanageable pressures on Chile's market for foreign exchange, the Chilean authorities instituted a mechanism of control, which consisted of auctioning off, every two weeks, certificates which gave the buyer the right to repatriate the discounted debt instruments. (Chile's capital account had not been decontrolled, so this solution was easy to implement.)

With these auctions, it was easy for Chile's Central Bank to stem the flood of demand for foreign currency. That flood had started because of the high profit potential implicit in the difference between the discounted price of Chilean bank bonds (originally around 60) and their par value (100). Initially, this "profit" was available to be divided in negotiations between the entrepreneurs and the debtor banks. But once the bi-weekly auctions were instituted, the Central Bank ended up with most of this arbitrage profit.

So the Chilean authorities gained in two ways — they were able to control the flow of demand for foreign exchange for this purpose, and they made a lot of money in the process. It did not take long for them to see the potential for using these same bi-weekly auctions to produce yet a third advantage for them — the capacity to create, at their own initiative, whatever demand for foreign currency (within feasible limits) was needed to produce an equilibrium of supply and demand within the band that they were targeting for the real exchange rate.

This was the beginning of what I would call a blissful period of real exchange rate targeting by the Central Bank of Chile. Supply and demand (including the Central Bank's own desired accumulation of international reserves) were always kept equal at a price within the target band, and the Central Bank made a lot of money in the process!! But the period of bliss was destined to end. Each passing year reduced the amount of discounted bonds that was still outstanding, and at the same time the size of the discount was progressively squeezed toward zero.

By the time Patricio Aylwin was elected as Chile's next President at the end of 1989, one can say that the permissions-auction idea had run its course. Yet the new government firmly believed in the idea of trying to keep the real exchange rate at an export-incentive level. But how to do it? Here they took a clue from the earlier, highly successful policy. That policy had in effect amounted to the replacement of discounted foreign debt denominated in dollars by newly issued domestic debt (of the Chilean debtor banks) denominated in pesos. That is, during 1985-89, the policy had fostered a reduction of foreign dollar liabilities plus a rise in peso liabilities of these banks. A very close counterpart of this could be achieved, it was thought, by effecting a rise in dollar assets of the country (held abroad) compensated by a rise of peso liabilities. Thus began a systematic policy (known as sterilized intervention) of the Central Bank issuing bonds on the local market, and using the proceeds to build up dollar balances abroad.

The policy of building up dollar balances abroad certainly "worked" in the literal sense. The international reserves of Chile's Central Bank stood at \$3.6 billion just after President Aylwin's election in December, 1989. By the end of 1990 they had risen to \$6.1 billion; they reached \$9.2 billion by the end of 1992, \$13.1 billion by the end of 1994, and \$17.3 billion by the end of 1997. This success, however, masked two problems, one of "Central Bank losses", the other of the "reflux of capital".

Although the "new" policy, under which the Central Bank of Chile borrowed in the home market, then demanded dollars (in order to prop up the real exchange rate), and finally placed those dollars abroad in the world financial markets bore a close resemblance to the old policy (of repatriating discounted debt), it differed dramatically in its effect on Central Bank earnings. Whereas the "old" policy brought a regular flow of cash (the proceeds of the bi-weekly auctions) into the coffers of the Central Bank, the "new" policy generated nothing but losses. These stemmed from the fact that the interest rate paid on the peso bonds issued by the Central Bank was significantly higher than that yielded by the dollar denominated securities and deposits that were acquired using the proceeds from the sale of the bonds. Interest rates on both sides of this equation varied through time, but they always signified losses for the Central Bank. An example of the discrepancy can be drawn from recent experience — with the Central Bank paying 7 to 8 percent on peso bonds indexed to the Chilean price level, while the proceeds of those bonds were being used to buy securities yielding an average nominal return (in dollars) of only 4 to 5 percent. Since over the period since 1990 the peso has appreciated significantly in real terms (in spite of the Central Bank's efforts), the loss was significantly greater than the 2-4 percentage point differential between the real peso rate paid and the dollar rate received. Moreover, the Central Bank loss in this borrowing-cum-placement operation has an automatic tendency to grow through time, so long as the operation is itself continuing. This can be seen by contemplating the growth in Chile's international reserves. If all of the growth from \$3 billion in 1989 to \$17 billion in 1997 was a reflection of operations of this type it would mean that the Central Bank would be taking its loss on an outstanding stock of bonds equal to the full increment (\$14 billion) of reserves that those bonds had financed. Taking an illustrative figure of 5 percentage points as the net loss per annum, we would calculate the loss at .05 x \$3 billion, or \$150 million during 1991 (when total reserves were about \$6 billion), rising to 0.5 x \$14 billion, or \$700 million by 1997, when Chile's foreign reserves had grown to \$17 billion. The cumulation of these losses, and the prospect of future losses that would be linked to the extent of future reliance on similar operations, was certainly partly responsible for the acceptance, by Chile's Central Bank, of a downward drift in the real exchange rate in the years after 1989.

The "reflux" problem was related to the operation just described. As the Central Bank sold additional bonds on the local market, the interest rate within Chile tended to be driven higher — i.e., above the level where it otherwise would have found its equilibrium. This higher interest rate within Chile made it more attractive for both foreigners and Chileans to shift money from, say, New York to the Santiago market. Thus, if the Central Bank were adding \$4 billion to its international reserves in New York, perhaps a quarter or a third or half of that amount would flow back to Chile as an "induced" private capital flow. We do not know the precise fraction of funds put abroad that came back to Chile as an induced "reflux". But we do know that the Central Bank took the problem very seriously.

The response of the Chile's Central Bank to the "reflux" problem was to institute what was in effect a tax on flows of short-term capital into the country. This was accomplished by a requirement that 30% of any inflow of short-term funds be placed in a zero-interest deposit at the Central Bank, for a period of a year. Thus, if these funds could have earned a 10% interest rate in the local market, the effect would have been the same as a tax of 3 percentage points. (Indeed, in the latter part of the period, investors could simply pay the Central Bank an "up front" fee of three percentage points of the capital flow in question, thus "buying out" of the deposit requirements.)

The 30% deposit requirement (and more recently the option of a 3% fee in lieu of a deposit) stayed in effect until very recently. In the wake of the so-called Asian crisis, however, the deposit was first reduced from 30 to 10 percent, and subsequently (late in 1998) eliminated entirely. By that point the Chilean authorities were more interested in attracting capital to the country than in preventing too much of it from coming.

Argentina. 1995-2000. The big real exchange rate lesson to be drawn from Argentina's experience in this period is how difficult and painful it can be for a country to try to achieve a real exchange rate devaluation through a process of internal deflation.

There is an easy litany that one can use in instructing the uninitiated about the real exchange rate. Let us call the nominal exchange rate with the dollar (or any other chosen major currency) E — the nominal price of the nominal dollar. Deflate this by a general price index (π_d) of the country in question and you get E/π_d — the real price of the nominal dollar. Multiply this by an index (π^*) of the dollar prices of tradable goods and you get $E\pi^*/\pi_d$ — the real price of the real dollar[1].

From this definition ($E\pi^*/\pi_d$) of the real exchange rate it can easily be seen that any change that can be accomplished by a change in E can also in principle be achieved by an inversely proportional change in pd. Indeed, movements in pd are the main mechanism by which the RER adjusts, under any fixed exchange rate system. We have an enormous list of cases in which major declines (appreciations) of the real exchange rate have taken place successfully while the nominal rate E was fixed. But we have very few cases of successful major increases (depreciations) of the real exchange brought about by downward movements of the internal price level. These are the cases that are very hard to find.

The reason is apparent from the case of Chile in 1981-82. Chile's 1975-81 boom really came to its peak on the second quarter of 1981, when the rate of unemployment (which had been coming down but was mostly in double digits from 1975 through 1980), finally reached 8% in June 1981. Then the debt crisis struck, and the rate of unemployment rose from 8 to over 28 percent in the lapse of barely a year. Chile was operating with a fixed exchange rate of 39 pesos to the dollar. But huge capital inflows had brought about a major fall in the RER, as the Chilean consumer price index (1985 = 100), had risen from 27 to 45 while the nominal rate remained fixed. This major appreciation of Chile's RER occurred under a fixed nominal rate, while its international reserves grew, while real GDP grew at around 8% per year, and while international reserves were reaching record levels. But only misery followed starting in late 1981, when a major RER adjustment in the opposite direction was called for.

The reason for this asymmetry is not hard to find — it is the oft-noted and well-documented fact that wage and price levels tend to be much more rigid in a downward than in an upward direction. Sometimes one encounters economists and others who try to dispute this fact by pointing to cases of prices (like those of primary commodities) that fluctuate up and down symmetrically, and by finding instances in which workers in certain firms and industries

[1] This same number is also the real price of the real deutschmark, for we get E' (the nominal price of the nominal DM) by dividing E (pesos per dollar) by H, the number of marks per dollar, and we get π', the index of the DM prices of tradable goods by multiplying π^* times H. So $\pi^* E/\pi_d = (\pi^* H)(E/H)/\pi_d = \pi' E'/\pi_d$. In the same way it can be shown that a country's real exchange rates with the pound, franc and yen are all exactly the same as those with the dollar and with the DM. In short, the real exchange rate is not a bilateral variable but a variable signifying a country's connection with the world market for tradable goods and services. In this paper we use the dollar as the currency of reference because of its relative importance, and because most quotations of countries' exchange rates refer to the local currency price of the dollar.

have willingly accepted reductions in their nominal wages. Such evidence can be perfectly true, but it does not speak to the issue of real exchange rate adjustment via deflation. To deal with that issue one needs to find examples of important increases in the real exchange rate that were brought about mainly through a declining price level. But when Chile's debt crisis struck, the general price level did not fall. Instead, economic activity fell, and unemployment skyrocketed to over 28%. Chile's government adamantly defended the fixed exchange rate to the last moment, when it felt it had no alternative but to devalue the peso. What this means is that this Chilean experience qualifies as a devaluation crisis, not as a case of successful deflation under a fixed exchange rate system. The same is true for the vast majority of other cases where a major upward adjustment of the RER was called for (by the market forces of supply and demand). Since devaluation came soon after the crisis struck, in all these cases, they do not allow us to see a full adjustment process with a fixed exchange rate.

The economics literature treats one famous case — that of the British pound in the 1920s. Here the disequilibrium of the real exchange rate was created by the British authorities themselves when, after the end of the First World War, they imposed a huge appreciation of the nominal exchange rate (which had been allowed to float during the war). This is generally regarded as a huge policy mistake, as it set in motion a lengthy process of internal deflation, leading some economists to call the 1920s a "lost decade" for the British economy.

Argentina's situation in the 1990s was quite different from Britain's in the 1920s, in that one can not blame the Argentine authorities for a poor choice of the parity at which they fixed their exchange rate. But they carried with them a different burden — the consequences of three near-hyperinflations within a span of less than 25 years. Argentina's inflation rate had hit 444% in 1976, 672% in 1985, and 3000% in 1989. By the end of the third such episode, the exchange rate was being used as the general "inflation signal" of the economy. Shopkeepers, barbers, plumbers, restaurants — just about everybody was setting their prices in dollars, then translating them into australes at the latest exchange rate that was reported over the radio. It was this practice that produced the real exchange rate that prevailed at the point when the parity of one new peso per dollar was set. Had the parity been set at two new pesos per dollar, the initial price level would simply have been twice as high, with the initial RER being just the same.

This was the historical process by which Argentina came to have a fixed parity with the dollar, as a consequence of which her initial real exchange rate almost came as an "act of God", being beyond the control of the authorities. This parity served the interests of Argentina pretty well as the economy grew at an average rate of nearly 9% per annum over the years 1991 (when the parity was set) through 1994. All hell broke lose, however, in the wake of the

Mexican crisis of December, 1994. Within a single quarter after that crisis, Argentina lost a third of its gross international reserves and fully half of its net reserves. Only by imaginative emergency moves were the authorities able to prevent a total collapse of the money supply, and even so M2 fell by around 12% in a single quarter.

The Mexican crisis without a doubt changed the equilibrium real exchange rate of the Argentine economy, principally through its effect on capital flows. Thus what had up to 1994 been an RER that was reasonably close to equilibrium, now became an RER that was substantially below its new (1995 and after) equilibrium. Had Argentina been "any ordinary country", the natural remedy would have been a substantial devaluation of the currency. But Argentina economists of all stripes argued against this solution because, they all felt, it would lead the Argentine public to essentially abandon the peso (the new unit as of the establishment of parity in 1991) and run completely to dollars and other foreign currencies.

So the Argentines have stuck with their parity, bearing it and its consequences as the curse of their inflationary history. But these consequences have been severe. Despite the strong deflationary pressures, the best the consumer price index could do is to hold steady for the five years 1995 through 1999. The producer price level was slightly more responsive to the deflationary pressures, reaching an index level of 95 in 1999 [with 1995 = 100]. But the failure to achieve equilibrium was super-evident in Argentina's unemployment experience. Over the whole period from 1995 onward, the unemployment rate has averaged about 15%, and has not fallen below 12.5%. Argentina has been unlucky in that Asian, Russian and Brazilian shocks have followed the Mexican one like the waves of the ocean. But there can be little doubt that Argentina would have been better off if it had been able (like its neighbor, Brazil) to use a nominal devaluation as a device to bring its real exchange rate into closer accord with its equilibrium level. Fixing the exchange rate in 1991 was not a mistake, and not a curse. The economy thrived for four years, just as the Chilean economy had thrived for two years under a fixed exchange rate before the debt crisis of 1981–82 struck. But in the presence of strong negative external shocks, a prompt and decisive devaluation (or freeing of the exchange rate) would under normal circumstances have been the natural solution for Argentina as of 1995. It would surely have made the necessary RER adjustment more palatable and less costly. Argentina's real curse is that her inflationary history has precluded her from using the policy instrument — a freeing of the exchange rate or a sharp devaluation — that would normally be most appropriate to resolve her recent and current disequilibrium.

More On Sterilized Intervention

Sterilized intervention is probably as old as central banking itself — maybe even older, as it quite likely was also practiced by the "leading private banks" that were the precursors of today's central banks.

In a fully operative fixed exchange rate system, the Central Bank buys and sells foreign exchange at the specified rate. In this process, it naturally accumulates and decumulates international reserves. It seems at first sight that these holdings of reserves are beyond its influence, being simply the result of the simple acts of buying and selling at the fixed rate. But the truth is much more complicated. In a "pure" system, the pesos emitted by the Central Bank would serve as a base for a general monetary expansion. This would put more money in the hands of the public, very likely in excess of what they really wanted to hold. The result would be that they would want to spend the excess, on goods, services and financial instruments. In these acts of spending they would cause imports to increase as they spent on importables, and exports to decrease as they spent on exportables. An outflow of international reserves would typically result, which would only come to an end when the amount of money in the system was once again in accord with what people were willing to hold, given the prevailing levels of prices and incomes.

Unless the underlying conditions of the economy changed in some important way, this process that started from a full equilibrium with an amount Ro of international reserves, and then received a "shock" of DR to those reserves, would end up with reserves back at or near Ro. The extra money DM that came into being on the basis of DR would represent "unwanted monetary balances" and would tend to be spent. The part spent on tradables would be reflected in a loss of reserves. This is the process by which the original equilibrium reserves level (R_o) would be restored.

Now suppose that a Central Bank wanted to keep some or all of the increment ΔR in its reserves. What would it do? Quite obviously, it would have to try to short-circuit the process just described — by which people brought about a loss of reserves through their spending their undesired monetary balances. The natural and easy way to do this is to short-circuit the link by which the increment to reserves DR produces an induced increment (ΔM) in the money supply. This can be done by the Central Bank's operating on the other major asset of the banking system, namely domestic credit. So if domestic credit can be curtailed by enough so that the money supply is kept in consonance with what people want to hold, this will eliminate the scenario through which the initial increment (ΔR) of reserves is reversed and ultimately erased.

This is where sterilized intervention enters the picture. Central Banks use various devices to prevent or at least control the increment of money (ΔM) that is generated in response to an increment of reserves ΔR. Increases in interest rates, changes in the fractions of reserves that banks must hold against deposits, open market operations in which the Central Bank absorbs base money by selling bonds or other assets, direct regulation of expansions of bank credit — all these devices have been and are being employed by Central Banks. And important among the purposes for which they are used is sterilized intervention.

Sterilized intervention is not just a one-way street. The example above dealt with the Central Bank preventing an increment of reserves DR from having its full "natural" effect on the money supply. The same can happen in reverse — preventing a loss of international reserves from leading to a proportionate or nearly-proportionate fall in the money supply. This is precisely what the Argentine authorities successfully did in early 1995 in their efforts to prevent a huge loss of international reserves from leading to a corresponding collapse of the nation's monetary magnitudes.

I cannot claim any intimate knowledge of the Russian case, but as I read that country's simple monetary statistics, I believe I see strong evidence of sterilized intervention. An easy example can be drawn from the recent gyrations of the world price of petroleum. As this price fell from nearly $20 a barrel in 1997 to around $10 in December 1998-February 1999 Russia's international reserves were allowed to fall from a peak of over $20 billion in the second quarter of 1997 to a low of less than $7 billion in March of 1999. But when the oil price turned around and started to rise to bonanza levels, Russia's Central Bank allowed reserves to rise dramatically, so that by now they are again close to $20 billion. These are two good examples of what appears to be sterilized intervention.

Table 3 shows some examples of sterilized intervention by other countries. These cases were built up from an ongoing study by S. Wong, which deals with recent episodes of very large capital inflows. In column (1) the dates of the capital inflow episode are shown. Column (2) then gives the cumulative capital inflow over this period, expressed as a percentage of a year's GDP. Thus Chile's capital inflow over the nine years 1989 through 1997 amounted to some 60% of a year's GDP, equivalent to about 6.7% of GDP per year.

The third column of *Table 3* shows the accumulation of international reserves over the specified period. The fourth column simply gives the ratio of (3) to (2). Thus, in Chile's case, we see that 52% of the capital inflow ended up "reflected" in increased reserves. This did not happen by accident. We know, in the Chilean case, that those reserves were accumulated as a result of a conscious policy by the Central Bank of influencing the real exchange rate using the instrument of sterilized intervention. I certainly would not contend that all or even most of the other cases were the result of such a conscious policy. But there is little doubt concerning the ***fact*** of sterilized intervention in the other cases. And this would mean a corresponding

Table 3

STERILIZED INTERVENTION IN PERIODS OF CAPITAL INFLOW DURING EPISODES

Country	Period	Capital Inflow over Period	Accumulation of Reserves over Period	Rate (3) to (2)	RER* Ending/Before
	(1)	(2)	(3)	(4)	(5)
Argentina	1977–1981	7.19	6.86	0.95	57/149
Chile	1989–1997	60.24	31.29	0.52	73/111
Peru	1991–1997	39.22	19.31	0.49	74/100
Uruguay	1990–1997	43.85	12.85	0.29	54/107
Bolivia	1990–1997	43.85	12.85	0.29	90/95
Brazil	1992–1997	15.97	19.55	1.22	94/112
Korea	1990–1996	16.52	4.75	0.29	93/98
Malaysia	1989–1997	75.37	29.27	0.39	80/96
Indonesia	1990–1996	26.73	8.15	0.31	92/99
Singapore	1972–1987	232.27	129.77	0.56	102/108
Thailand	1990–1996	71.18	22.81	0.32	89/101

* In column (5) we attempt to show what happened to the real exchange rate over the period of capital inflow. It makes sense to use the RER the year ***before*** the start of the inflow period as the base. Similarly, because the "crisis" that ended the inflow sometimes occurs in the last year of the inflow, we take the penultimate year of inflow as our ending period.

effect on the real exchange rate, even if that were not the main purpose of the operation.

To see what actually happened to real exchange rates in these capital inflow episodes, we show in column (5) the ratio of ending RER/beginning RER. For this ratio we use as the beginning point the average RER of the year ***before*** the capital inflow started, and as the ending point the average RER of the year ***before*** it ended. (This guards against the possibility that the crisis which ended the capital inflow took place during a last year in which the net inflow was still positive, triggering a big increase in the RER which was really not the consequence of the capital inflow, but instead of its abrupt termination at some point in its final year.) One can see in column (5) the natural effect of capital inflows in causing the real price of the dollar (the RER) to fall. This tendency was mitigated but not obliterated by the sterilized interventions that the table documents.

As a final note on sterilized intervention let me return to the "reflux" problem mentioned in the analysis of the Chilean case. The intensity of this problem depends very much on the degree of integration of a country with the world capital market, and with the way in which that market assesses its "country risk". Recall that the reflux problem emerges when the country's accumulations of international reserves are to some degree offset by "induced" private capital flows in the opposite direction. Such flows would be induced by the squeezing of domestic credit in the country, which typically would cause interest rates to rise. It is this rise in interest rates that then operates to attract the induced "reflux" of funds. The reflux problem obviously depends on the degree of capital market linkage and on the degree of confidence that international market participants place in the country. This linkage and confidence were quite low for Chile and Argentina in the middle 1970s, so reflux was not a problem. Linkage and confidence were considerably better in the 1990s so by then the issue of reflux became a problem. Luxembourg, with its virtually complete integration and full confidence, has to be a country for which the reflux problem would be huge, which would mean that sterilized intervention would have little effect. It seems quite clear that in the present circumstances, Russia is more like Chile and Argentina in the middle 1970s than it is like those countries, not to mention Luxembourg, today. So I do not see any serious impediment to the effectiveness of sterilized intervention in Russia. Indeed, I believe we have seen the successful use of this instrument in both directions, during the past three years.

The Importance of "Sources of Growth" Analysis

The idea of breaking down a country's growth rate into a series of components due, respectively, to increase in labor input, increase in capital input, and a residual incorporating other influences has to be recognized as one of the 20th century's great advances in economic thinking. At the time of its inception it helped to: a) play down the role of physical capital and b) play up the role of "technical advance" as elements in the growth process. Very soon thereafter the role of human capital was given new attention. Still later the multi-faceted nature of the residual term came to the fore. My own predilection is to explicitly label this term "real cost reductions". This label does not change anything, but it helps remind us that this term does not just represent new inventions, or economies of scale, or externalities and spillovers but rather includes all of these things, plus improved personnel management, better office procedures, modernized inventory control, maybe even successful advertising campaigns, and many other paths to greater profits through greater efficiency.

This "disaggregated" view of the growth process does not fit very well in a framework structured around the concept of the aggregate production function. Rather, its natural point of focus is the firm, where every element of the process of growth must ultimately be reflected. This is true at least of the growth of GDP (which is what has traditionally been measured) since the GDP of a nation (or province or country) is nothing but the sum total of the GDP contributions of the entities located there. Focusing on the firm and even on breakdowns of growth by two- and three- and four-digit industries gives one a quite different appreciation of the nature of the growth process than one gets by thinking in terms of an aggregate production function. The more disaggregated one's focus, the more Schumpeterian becomes one's vision of the growth process. This is because the great under-appreciated fact of disaggregated growth analysis is the pervasiveness of real cost increases side by side with real cost reductions. In just about every disaggregated data set that one turns to there are losers as well as winners — and not just a few losers, but lots of them, often accounting for as much as a third or even half of initial value added.

Though some may gravitate toward attributing this to mere randomness, I feel this is like running away from the challenge posed by the phenomenon of widespread declines (side by side with increases) in total factor productivity (TFP). I believe, as Schumpeter did, that there is something about it which is not only systematic, but also quite of the essence of the growth process. On top of whatever simple randomness there is, we have the phenomenon of winners beating out losers, all over the economic landscape. The winners are those who find ways of producing the same products for less, or better products for the same money, or totally new products that attract consumer demand. The losers are those who suffer in this process, typically being driven back to production points where their average costs (which are the raw material that TFP analysis works with) are higher.

Policies that Promote (or Enable) Real Cost Reductions. Many different studies of the breakdown of growth into its components have come to the conclusion that high-growth situations tend to be characterized (among other things) by high rates of real cost reduction. These real cost reductions occur, in one sense or another, inside of business entities. So where does policy come into play? In some cases, like improving a highway network, it may directly "produce" reductions in real (in this case transport) costs. In others, like promoting research and development activities, it may involve operations that can actually "deliver" real cost reductions within the firm. But the overwhelming bulk of relevant policies work in neither of these ways. Instead, they play an "enabling" role, making it easier for firms to encounter new ways of reducing real costs.

First and foremost among growth-enabling policies is the ***control of serious inflation***. Much evidence shows that inflation inhibits economic growth. We earlier in this paper discussed three main ways in which this happens — a) the blurring of relative prices that invariably accompanies high inflation makes it hard for firms to perceive opportunities for real cost reduction; b) some of the investible funds that are generated in inflationary economies tend to be diverted to safer havens (like foreign currency or foreign bank and securities accounts), and c) the higher its rate, the greater the fraction of real resources dedicated to finding ways of turning the inflation process to one's private advantage (even though no overall gain to society is involved).

Surmounting inflation almost by definition entails pursuing ***more sensible fiscal and other macroeconomic policies***, but it is worth while to list such policies as a separate point. A macro-framework that is economically sound, and that in addition is expected to continue to be so in the future, opens the door to investments and cost-reducing activities that would otherwise be shunned.

Linked to sound macro-policies, but not quite the same thing, is the ***reduction of economic distortions***, most especially those put in place by the government itself. Taxes, tariffs, quotas, price controls, open and hidden subsidies — these are some of the more important of such distortions. Closely related are the distortions imposed by arbitrary regulations, restrictions, licensing procedures and the like. Some distortions are the inevitable accompaniment of government, but in most real-world cases there is wide scope for reducing their cost to the economy. The idea is to move from an economic system that has lots of "prices that lie" toward one in which there are fewer, and where the lies they tell are more like fibs and less like gross prevarications. This is important because, the greater the degree of distortion in the economy, the more cases there will be of actions that reduce real costs for the economic agents directly involved but that actually increase real costs from the standpoint of the economy as a whole. Ill-advised regulations not only work to keep real costs higher than they need to be; they also reduce the rate of growth by slowing the speed at which opportunities for real cost reduction are implemented.

Policies that Promote a More Open Economy. Without a doubt policies promoting freer trade in particular and a more open economy in general can be considered simply as a category under the general heading of policies that reduce economic distortions. But that would tend to underplay the critical role that openness appears to have played in just about every development success story of recent decades. People can argue about the nuances, but not only did exports and imports both grow dramatically in the great growth episodes of Japan, Taiwan, Korea, Spain, Portugal, Greece, Brazil, Chile and Argentina — but they grew even in relation to the very notable growth of GDP.

Openness seems to do much more than just eliminate triangles of excess burden stemming from tariffs, quotas and similar distortions. It appears also to unleash, or at least to have the potential for unleashing a new dynamism in previously stagnant or sluggish economies. I know it is hard for many of us economists to accept that economic agents are not always working equally hard to reduce real costs, but the evidence strongly suggests that businesses with a market whose security for the firm is more-or-less guaranteed (by high protection in one form or other) are more likely to take the comfortable route of sticking with routines that proved successful in the past. Once such businesses are exposed to the rigors of world market competition, they either adapt by reducing real costs or (usually gradually by a sequence of painful steps) fade out of the picture. Living with market competition for a period of time also tends to change the outlook of business firms, from a more-or-less static vision of finding a "cash cow" and milking it steadily over a long period to a more dynamic approach of making it part of their regular business routine to constantly look for newer and better products, processes and methods. In these ways, a country's turning its economy toward greater openness has an effect not only on the level of its GDP (the comparative static effect) but also on its rate of growth (the dynamic effect of trade liberalization).

Some Special Features of the Russian Case. Russia's history has bequeathed to it certain advantages and certain disadvantages with respect to the process of real cost reduction. The most obvious advantages are on the educational side, where it has a labor force that is far better prepared than those of the great bulk of countries with a comparable (or even greater) GDP per capita. This is an enormous plus, which is likely to become more and more important as other barriers to growth are overcome.

The list of disadvantages is pretty well-known. The legal framework has to be made more appropriate for a modern market economy. Economic activity must come to take place under "rules of the game" that are conducive to economic activity and that are appreciated by and enforced upon the whole range of market participants. Labor in particular must be able to move from place to place. I understand that the legal restrictions on such mobility have been lifted, but institutional restrictions (particularly the access of workers to housing in a new location) still have to be surmounted.

I would like to make special note of an inheritance from Russia's past that was particularly called to my attention during our visit. That is the characteristic pattern (from the Soviet era) of concentrating the production of a given item in a huge factory complex at a given place, often incorporating a vertical integration from very basic inputs all the way up to the finished final product. This organization of production tends to be highly bureaucratized, leaving little scope for cost-reducing initiatives. If one could only rewrite history!!! The search for real cost reduction would be far better served with many smaller factories, each seeking ways to reduce real cost, than with just one or two huge factories trying to do the same thing. One of the biggest challenges for stimulating economic growth in Russia is to figure out ways of generating imaginative cost-reducing ideas, of creating avenues of financing so that such ideas can be implemented, and of giving the resulting enterprises (be they old ones or new) a free competitive access to the internal and external marketplaces. This task is much harder, starting from a system built mainly of huge, integrated complexes. But that only makes it more of a challenge. In my view, the speed of Russia's progress out of its present depressed economic condition will depend greatly on how successful is the response to this challenge.

CREATING AN ENVIRONMENT FOR MAXIMUM SUSTAINABLE ECONOMIC GROWTH

James Gwartney

I. INTRODUCTION

Economic growth is the key to higher living standards. Output and income are closely linked. In fact, they are merely alternative ways of viewing the same thing. The value of output generates an equal amount of income for the resource owners producing the output. Correspondingly, expansion in the production of goods and services valued by people is the source of income growth, which provides for higher living standards. Over long periods, even differences in growth rates that are seemingly small can exert a major impact on living standards. For example, if two countries have the same initial income level, after 35 years the income of the country growing at 4 percent will be twice that of the country growing at 2 percent.

Modern growth theory is built on a classic 1956 article by Robert Solow[1]. Solow's work stresses the importance of labor, capital, and technology as the source of economic growth. Solow perceives of growth within the framework of a production function. Growth is the result of an expansion of inputs — more inputs lead to a larger output.

During the 1960s and 1970s, several researchers sought to measure the growth in labor force and the stock of physical capital and use these figures to estimate their contribution to the growth of output. The unexplained residual was thought to be the result of advancements in technology. More recent research has also stressed the importance of human capital, investments in

[1] *R. Solow*, "A Contribution to the Theory of Economic Growth" *Quarterly Journal of Economics*, Vol. 70 (February 1956), pp. 65-94.

education, training, and experience on the skill level of labor force participants.

Obviously, inputs play an important role in the growth process. Investment in physical capital (tools, structures, and machines) and human capital (education and training) can increase the productivity of workers. Technological advancement can also be important. Research and brainpower can be used to discover lower-cost methods of production and to produce valuable new products. Historically, important technological discoveries such as the steam and internal combustion engines, electricity, nuclear energy, the railroad, automobile, and airplane have dramatically altered our lives. The process continues. During the last 30 years, life-saving drugs, heart transplants, word processing equipment, personal computers, and electronic communications have transformed the way we live and work.

It is also abundantly clear that there is more to the growth process than expansion in inputs. The efficiency of input use is also critically important. Despite high rates of physical investment and labor forces that were relatively well educated, the performance of the centrally planned economies was poor, primarily because of their inefficient use of resources. Neither does access to more advanced technology guarantee growth. Developing countries are in a position to emulate (or import at low cost) technologies that have been successful in developed countries. Nonetheless, many continue to stagnate and fall further behind.

During the last decade, economists have began to integrate the quality of institutional and policy environment into their analysis of growth. In many ways, this "new growth theory" is a return to the approach of Adam Smith, who also stressed the importance of the economic environment.

Inputs are not created and used in a vacuum. The availability of resources and efficiency of their use is influenced by the institutional and policy environment. Models of growth that fail to incorporate institutional and policy factors are incomplete and ignore the central core of the growth process. The availability and efficient use of inputs is dependent on the quality of the institutional and policy environment. Countries with a sound economic environment attract (1) investors willing to supply resources and adopt technological improvements and (2) entrepreneurs willing to use resources efficiently and produce goods and services that are valued highly relative to their costs.

II. THE ENVIRONMENT FOR ECONOMIC GROWTH

Economic theory suggests several key institutions and policy factors that are important for the achievement of maximum economic growth. *Exhibit 1* lists them. This section will briefly discuss these factors and analyze their importance as a source of economic growth. We will also consider empirical evidence on this topic.

1. Secure property rights and political stability

A legal system committed to protecting individuals and their property is a minimal prerequisite for sustained economic growth. Private property rights protect property and property owners against those seeking to acquire wealth by violence, theft, or fraud. Without well-defined and well-enforced property rights, investors will not be willing to buy equipment and other fixed assets that fuel economic growth.

Exhibit 1

KEY FACTORS FOR THE ACHIEVEMENT OF MAXIMUM ECONOMIC GROWTH

1. Secure property rights and political stability
2. Stable money and prices
3. Competitive markets
4. Freedom to trade with foreigners
5. Appropriate size of government

The most important thing about private ownership is the incentives it provides. Private ownership holds people accountable for their actions. Under private ownership, people get ahead by providing things that other people value and by engaging in actions that increase the value of resources. To use a good or resource, you must buy or lease it from the owner. Each economic participant faces the cost of using scarce resources. To succeed in business, you must bid resources away from other potential users and provide customers with goods and services more valuable than the cost of production. There is therefore a strong incentive to use resources productively — to discover and undertake actions that generate economic growth.[2]

A volatile political climate undermines the security of property rights. Some governments have confiscated physical and financial assets, imposed

[2] For evidence that a legal system which protects property rights, enforces contracts, and relies on the rule of law to settle disputes promotes economic growth, see Stephen Knack and Philip Keefer, "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures", *Economics and Politics*, Vol. 7 (1995), pp. 207-27. See also Tom Bethell, *The Noblest Triumph* (New York, St. Martin's Press, 1998).

punitive taxes, and used regulations to punish their political enemies. Countries with this kind of history find it difficult to guarantee the security of property rights and gain the confidence of potential investors.

2. Stable money and prices

A stable monetary environment provides the foundation for the efficient operation of a market economy. In contrast, monetary and price instability generate uncertainty and undermine the security of contracts. When prices increase 10 percent one year, 30 percent the next year, 15 percent the year after that, and so on, individuals and businesses are unable to develop sensible long-term plans. In response, people save less, and businesses move their activities to countries with a more stable monetary environment. Foreigners invest elsewhere, and citizens often go to great lengths to get their savings out of the country. As a result, potential gains from capital formation and business activities are lost.

3. Competitive markets

Competition is the disciplining force of a market economy. As Adam Smith stressed long ago, when competition is present, even self-interested individuals engage in actions that promote the general welfare. In a competitive environment, producers must woo the dollar "votes" of consumers away from other suppliers. To do so, they must produce goods efficiently and provide consumers with worthwhile products. Sellers who cannot provide quality goods at competitive prices are driven from the market. This process leads to improvement in both products and production methods, while directing resources toward projects where they are able to produce more value. It is a powerful stimulus for economic growth.

Such policies as unhampered entry into business and freedom of exchange with foreigners enhance competition and thereby help to promote economic progress. In contrast, business subsidies, price controls, entry restraints, and trade restrictions stifle competition and retard economic growth.

4. Freedom to trade with foreigners

Trade is vitally important for growth and prosperity. When the residents of a country are permitted to buy from suppliers offering the best deal and sell to purchasers willing to pay the most attractive prices, they will be able to concentrate more of their resources on the things they do well (produce at a low cost), while trading for those they do poorly. As a result, they will be able to produce a larger output than would otherwise be possible. Trade also increases the competitiveness of markets and creates additional gains from the adoption of large-scale production methods and the spread of technology. All this enhances efficiency and promotes growth[3].

In essence, the United States is a large free trade zone. This is an important factor that has contributed to the growth and long-term success of Americans. Just as free trade among the 50 U.S. states enhances the living standards of Americans, freedom of exchange across national boundaries will enhance the well being of citizens throughout the world.

In order to test the linkage between free trade and economic prosperity more rigorously, the staff of the Joint Economic Committee developed a Trade Openness Index. This index measures the degree to which citizens in various countries are free to exchange goods and services with residents of other countries. The index is based on four factors: (1) tariff rates, (2) presence or absence of a black market for foreign currency, (3) size of the trade sector as a share of the economy, and (4) restrictions on capital movements. High ratings are given to countries with low tariffs, no black market for foreign exchange, a large trade sector (given the country's size and locational characteristics), and few restrictions on the inflow or outflow of capital[4].

It was possible to derive the index for 97 countries for the period 1980-1997. Exhibit 2 lists the countries with the 12 highest and 12 lowest average ratings for openness during this 18 year period. The 12 most open economies had low tariffs, liberal currency conversion policies, large trade sectors, and few restraints on the inflow and outflow of capital. Hong Kong, Singapore, Belgium, Panama, Luxembourg, and Germany head the list; the United States ranks seventh, tied with the United Kingdom and the Netherlands. In contrast, the least open economies — Myanmar, Bangladesh, Sierra Leone, Burundi, Iran, Uganda, and Syria — persistently followed policies that restricted trade.

If trade makes a difference, countries that are open over a long time should both achieve higher levels of income and grow faster[5]. As Exhibit 2 shows, this has indeed been the case. The GDP per person of the 12 most open economies in 1997

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[3] For more on the impact of trade on the economy, see Joint Economic Committee, Office of the Chairman, "12 Myths of International Trade," July 1999, available online at <http://www.senate.gov/~jec/trade1.html>.

[4] The four components of the index were weighted equally. The country data on tariffs, black market exchange rate premiums, the actual size of the trade sector relative to the expected size, and a categorical rating indicative of capital market restrictions were all placed on a 0 to 10 scale. For details, see James Gwartney and Robert Lawson, *Economic Freedom of the World: 2000 Annual Report* (Vancouver, Fraser Institute, 2000). The expected size of the trade sector is influenced by both country size and location. Thus, the model used to estimate the expected size of the trade sector is adjusted for size of country (population and geographic area) and locational characteristics (length of coastline and distance from concentrations of demand).

[5] For an excellent technical analysis of the relationship between international trade and economic growth, see Jeffrey A. Frankel and David Romer, "Does Trade Cause Growth?", *American Economic Review*, June 1999.

Exhibit 2

TRADE OPENNESS, INCOME, AND GROWTH

	Trade Openness Index (avg)	Real GDP per person	Average annual growth of real GDP per person
	1980–1997	1997	1980–1997
Most open economies			
Hong Kong	9.9	$26,150	4.7%
Singapore	9.8	$30,756	5.8%
Belgium	9.0	$23,763	1.7%
Panama	8.8	$7,521	0.7%
Luxembourg	8.5	$36,190	3.7%
Germany	8.5	$22,693	1.6%*
United Kingdom	8.4	$21,825	1.8%
United States	8.4	$30,610	1.6%
Netherlands	8.4	$22,717	1.6%
Switzerland	8.1	$27,985	0.8%
Malaysia	7.9	$11,274	4.2%
Canada	7.7	$23,272	1.2%
Average	***8.6***	***$23,730***	***2.3%***
Least open economies			
Algeria	3.0	$4,887	–0.9%
Madagaskar	3.0	$971	–2.2%
Nigeria	2.9	$935	–0.9%
Argentina	2.8	$10,600	0.4%
Ghana	2.8	$1,913	–0.1%
Syria	2.4	$3,182	1.0%
Uganda	2.4	$1,117	2.2%*
Iran	2.0	$6,206	–0.2%
Burundi	1.4	$646	–1.2%
Sierra Leone	1.4	$538	–3.9%
Bangladesh	0.6	$1,117	2.4%
Myanmar	0.2	$1,287	1.7%
Average	***2.1***	***$2,783***	***–0.3%***

Sources: Trade openness (0-10 scale) derived by JES staff. Data are from CIA, *Handbook of International Financial Statistics*; World Bank, *World Development Indicators*, 1999; IMF, *International Financial Statistics Yearbook*, 1999. GDP per person is in 1998 dollars, derived by purchasing power parity method.

Note: * Data for Germany are for West Germany only prior to unification. Due to data restrictions, Uganda's average annual growth is only 1982.

averaged \$23,730 — eight times the average of \$2,783 for the 12 least open economies. The 12 most open economies grew on average 2.3 percent a year during 1980-97, compared to *minus* 0.3 percent a year for the 12 least open economies. The striking differences in both the income levels and growth rates illustrate the importance of international trade as a source of growth and prosperity.

A more detailed analysis of the 97 countries revealed that there was a strong positive relationship between both (1) openness and per capita GDP and (2) openness and rate of economic growth. Of course, economic performance is influenced by factors other than openness. In particular, institutions and policies that provide for more secure property rights and lead to persistent stability in the general price level are also important. These factors were also integrated into the analysis of the 97 countries in order to determine if openness exerts an independent impact. The results indicated that even after the positive effects of secure property rights and price stability were accounted for, the more open economies had higher income levels and achieved more rapid growth rates during 1980-1997 than those that were less open[6].

5. Appropriate size of government

Governments can enhance growth by providing an infrastructure for the smooth operation of markets. A legal system capable of protecting people and property, and a monetary system that provides price stability are the central elements in this area. In addition, governments may enhance growth by providing a limited set of goods — which economists call public goods — that are troublesome to supply through markets because of the difficulties of making all who enjoy the goods pay for them. Examples include national defense, flood control, and air and water quality. Government spending that expands educational opportunity and the development of human capital may also stimulate economic growth.

However, a government that grows too large retards economic growth in a number of ways. First, as government grows, relative to the market sector, the returns to government activity diminish. The larger the government, the greater is its involvement in activities it does poorly. Second, more government means higher taxes. As taxes take more earnings from citizens, the incentive to invest, develop resources, and engage in productive activities declines. Third, compared to the market sector, government is less innovative

[6] The more open economies have followed monetary, fiscal, and regulatory policies more consistent with high rates of investment and rapid economic growth. This highlights another important point: openness gives policy makers strong incentives to establish an environment that is attractive for investment in physical capital, education, and technology. Failure to do so will result in low investment rates, capital flight, and a "brain drain." Thus, in addition to its direct effects, openness indirectly promotes growth by encouraging the adoption of sound policies in other areas.

and less responsive to change. Growth is a discovery process. In the market sector, entrepreneurs have strong incentives to discover new and improved technologies, better methods of doing things, and opportunities that were previously overlooked. Also, they are in a position to act quickly, as new opportunities arise[7]. In government, the nature of the political process lengthens the time required to modify bad choices (such as ending ineffective programs) and adjust to changing circumstances. As the size of government expands, the sphere of innovative behavior shrinks.

In addition, as government grows, it becomes more heavily involved in redistributing income and in regulatory activism. This will cause people to spend more time seeking favors from the government and less time producing goods and services for consumers[8].

In summary, government provision of certain core goods and services can enhance economic growth. However, as government grows larger it eventually retards growth as it increasingly undertakes activities for which it is ill suited. Exhibit 3 illustrates the expected relationship between the size of government and economic growth, assuming that government undertakes the most beneficial activities first. As the size of government (horizontal axis) expands from zero, initially the growth rate of the economy — measured on the vertical axis — increases. The part of the curve from point A to point B shows the initial positive impact of more government on economic growth. However, as government becomes increasingly large, it spends more and more on activities that yield few or even negative benefits. The rate of economic growth falls, as shown by the part of the curve to the right of point B[9]. A government that engages in appropriate activities and is not too large maximizes economic growth. Expanding government beyond the optimal size retards growth.

It is informative to view the growth of the long-time members of the Organisation for Economic Co-operation and Development (OECD) within the framework of this model. In many respects, the institutions and policies of these countries are similar. All are stable democracies with mature legal systems capable of protecting property rights. During the 1990s, inflation in all has been low and relatively stable. With the possible exception of Japan, all are relatively open economies with similar trade policies. Each has a well-educated labor force.

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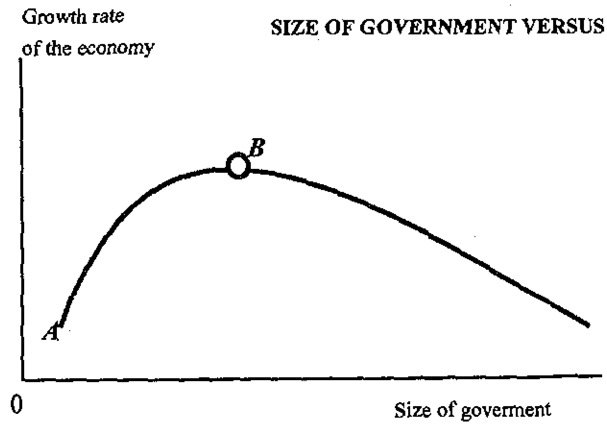
[7] The writings of Israel Kirzner and Joseph Schumpeter highlight this point. See Israel M. Kirzner, *Competition and Entrepreneurship* (Chicago, University of Chicago Press, 1973); and Joseph A. Schumpeter, *The Theory of Economic Development*, trans. Redvers Opie (Cambridge, Massachusetts, Harvard University Press, 1934, original German-language publication 1912).

[8] Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft", *Western Economic Journal*, Vol. 5 (1967), pp. 224-32; and Anne O. Krueger, "The Political Economy of the Rent-Seeking Society", *American Economic Review*, Vol. 64 (1974), pp. 291-303.

[9] For a formal model with the characteristics outlined here, see Robert J. Barro, "Government Spending in a Simple Model of Endogenous Growth", *Journal of Political Economy*, Vol. 98 (1990), pp. S103-S125.

Exhibit 3

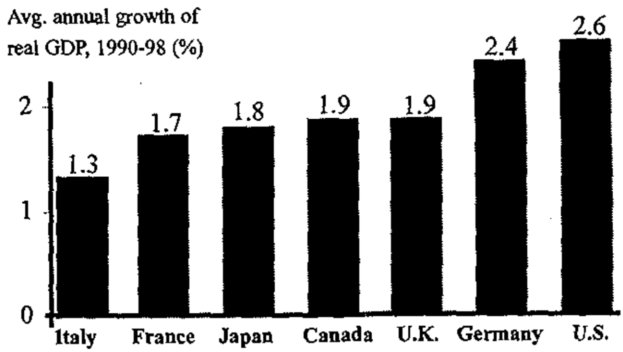
SIZE OF GOVERNMENT VERSUS GROWTH



There is considerable variation, however, with regard to the size and growth of government. Among the seven largest high-income industrial economies, government is smaller and its growth has been less rapid in the United States. As Exhibit 4 shows, during the 1990s the United States has been the fastest growing of the seven largest industrial economies. The U.S. growth rate has been twice that of Italy and significantly higher than the rates of Japan, the United Kingdom, France, and Canada. Only Germany has achieved similar growth during the decade, and during the past six years even its growth has been sluggish — just 1.5 percent a year.

Exhibit 4

GROWTH OF THE 7 LARGEST INDUSTRIAL ECONOMIES DURING THE 1990s



Sources: *OECD Historical Statistics 1960-94;*
OECD Economic Outlook, 6/1999.

It is also interesting to view the relationship between size of government and economic growth for a broader range of OECD countries. As the upper part of *Exhibit 5* indicates, seven long-time OECD members — Sweden, Denmark, France, Belgium, Austria, Finland, and Italy — had total government expenditures of 48 percent or more of GDP in 1997. Annual economic growth during the 1990s in these "big government" economies ranged from Sweden's 1.1 percent to Denmark's 2.5 percent. The average growth of the seven nations was 1.7 percent. By way of comparison, three long-time OECD members — Ireland, Australia, and the U.S. — had total government expenditures of less than 35 percent of GDP in 1997. Annual economic growth in these "smaller government" economies ranged from 2.6 percent in the United States to 7.1 percent in Ireland. Their group average was 4.3 percent, more than twice the average for the big government group. The highest growth rate among the big government group — Denmark's 2.5 percent — was slightly below the lowest rate among the small government group.

Exhibit 6 looks at the relationship between the size of government and growth over a longer period — the last four decades. The size of government at the beginning of a decade is measured on the horizontal axis, while the growth of real GDP during that decade is measured on the vertical axis. The graph contains four dots for each of the 21 OECD members on which data were available. The plot shows a clear relationship: slower growth is associated with more government spending[10].

In the 1960s and 1970s, government spending as a share of GDP ranged from a low of around 15 percent to a high of more than 60 percent. The dots representing low levels of government — less than 20 percent of GDP — are either almost on the regression line or well above it. There is therefore no evidence that government expenditures were too small to maximize growth in any of these countries. Put another way, the evidence indicates that all of these countries were to the right of point B on the curve in *Exhibit 5*[11].

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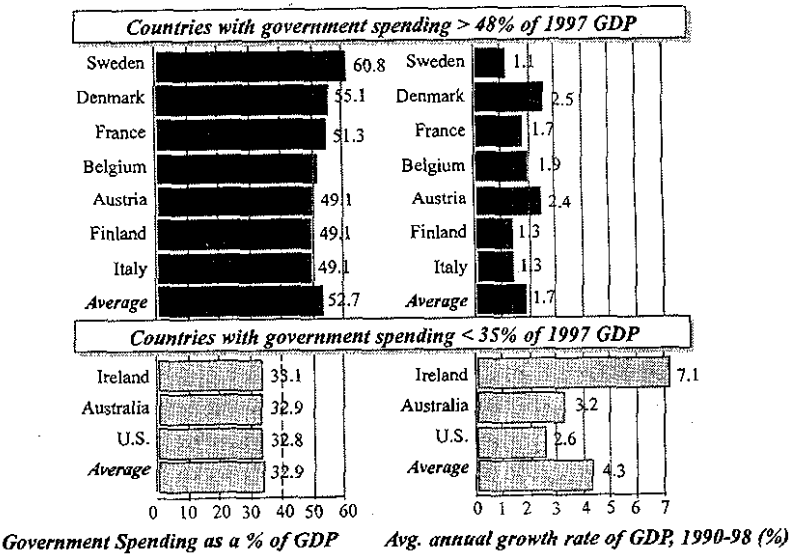
[10] The equation in Exhibit 6, known as a regression equation, expresses the relationship numerically. The equation includes "dummy variables" (adjustment factors) for the data points in the 1960s and 1970s to take into account that growth rates then were significantly different than during other decades. The variable for the size of government is significant at the 99 percent level, meaning that there is only a 1 percent possibility that such a result could have been generated purely by chance. The coefficient is -.07, meaning that a 10 percentage point increase in size of government as a share of GDP reduces the long-term annual growth rate of real GDP by seven-tenths of a percent. The R2 statistic indicates that the variable for the size of government and the dummy variables for the 1960s and 1970s "explain" 62 percent of the variation in growth among the 21 countries involved.

[11] For additional details, see James Gwartney, Robert Lawson, and Randall Holcombe, "The Size and Functions of Government and Economic Growth", Joint Economic Committee, April 1998, available online at <http://www.house.gov/jec/growth/function/function.htm>; Edgar Peden, "Productivity in the United States and Its Relationship to Government Activity: An Analysis of 57 Years, 1929-1986", *Public Choice*, vol. 69 (1991), pp. 153-73; and Gerald Scully, *What Is the Optimal Size of Government in the United States*? (Dallas, National Center for Policy Analysis, 1994). While the methods employed by each study were different, all found that the growth-maximizing size of government was considerably smaller than the actual size of government in all OECD countries.

Exhibit 5

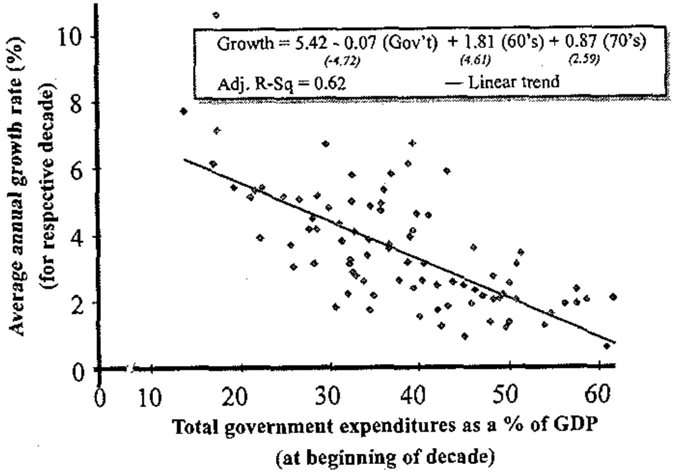
ECONOMIC GROWTH OF OECD COUNTRIES, BIG VERSUS SMALL GOVERNMENT



Source: *OECD Historical Statistics: 1960-1994*; *OECD Economic Outlook, 6/1999.*

Exhibit 6

ECONOMIC GROWTH DECLINES AS SIZE OF GOVERNMENT INCREASES, 1960–1998



Source: Derived from *OECD Historical Statistics: 1960-1994* and *OECD Economic Outlook, 6/1999.* Analysis is based upon 84 observations (21 OECD countrries for which data were available times 4 decades).

During the last four decades, the size of government has expanded in every OECD country, while the rate of growth in every country, with the exception of Ireland, has fallen. However, there has been considerable variation in the magnitude of government expansion. If big government retards long-term growth, as Exhibits 5 and 6 imply, the countries with the largest increases in government should experience the sharpest reductions in growth.

Since 1960, the size of government as a share of GDP has increased 20 percentage points or more in six long-time OECD countries: Denmark, Finland, Greece, Portugal, Spain, and Sweden. On the other hand, it has increased 10 percentage points or less in four long-time OECD countries: Iceland, Ireland, the United Kingdom, and the United States. Exhibit 7 presents data on the growth rates of these two groups, along with the average for OECD countries (bottom line of the table). Among the "rapid expansion in government" group, the average annual growth of real GDP fell from 6.4 percent in 1960-65 to 1.9 percent in the 1990s, a drop of 4.5 percentage points. Among the "slower expansion in government" group, the average annual growth of real GDP fell from 4.1 percent in 1960-65 to 3.5 percent in the 1990s, a drop of only 0.6 percentage points. The best country in the "rapid expansion in government" group experienced a greater drop in growth than the worst country in the "slower expansion in government" group[12].

In 1960, government expenditures as a share of GDP for every country in the top part of Exhibit 7 exceeded the OECD average (bottom line of table) of 27.3 percent. At the same time, their average GDP growth rate of 4.1 percent was below the OECD average of 5.6 percent during the 1960s. The situation was exactly the opposite for this same set of countries in the 1990s. After their ratios of government expenditures to GDP dropped below the OECD average, their growth rates rose above the average. The reverse happened to the nations in the bottom part of Exhibit 7. In 1960 their government expenditures as a share of GDP were below the OECD average, and their average GDP growth rates were higher than the OECD average. By 1998 their government expenditures had risen above the OECD average and their average growth rates had fallen below it. Because these statistics are for the same countries and country groupings, they are particularly revealing.

[12] While the growth of government in Japan was slightly less than 20 percentage points, it is revealing nonetheless. At the beginning of the 1960s, government spending was only 17.5 percent of GDP, and it averaged only 22 percent of GDP during the decade. With small government, the Japanese economy registered an average annual growth rate of 10.4 percent in the 1960s. Over the next three decades, the Japanese government grew steadily; by 1998 government spending was 36.9 percent of GDP. Average annual economic growth fell to 5.3 percent in the 1970s, 3.8 percent in the 1980s, and 1.6 percent in the 1990s.

Exhibit 7

ECONOMIC GROWTH IN OECD COUNTRIES WITH MOST AND LEAST EXPANSION IN GOVERNMENT

	Government as % of GDP			Real GDP Growth (% per year)		
	1960 (1)	1998 (2)	Change (3)	'60–'65 (4)	'90–'98 (5)	Change (6)
Countries with least growth in size of gov't as a share of GDP (<10%)						
Iceland	28.2	36.2	*8.0*	4.5	2.3	*–2.2*
Ireland	28.0	33.1	*5.1*	4.1	7.1	*3.0*
United Kingdom	32.2	40.2	*8.0*	3.5	1.9	*–1.6*
United States	28.4	32.8	*4.4*	4.4	2.6	*–1.8*
Average	***29.2***	***35.6***	***6.4***	***4.1***	***3.5***	***–0.6***
Countries with most growth in size of gov't as a share of GDP (>20%)						
Denmark	24.8	55.1	*30.3*	5.9	2.5	*–3.4*
Finland	26.6	49.1	*22.5*	5.6	1.3	*–4.3*
Greece	17.4	41.8	*24.4*	7.2	1.7	*–5.5*
Portugal	17.0	43.6	*26.6*	6.5	2.7	*–3.8*
Spain	13.7	41.8	*28.1*	8.5	2.2	*–6.3*
Sweden	31.0	60.8	*29.8*	4.9	1.1	*–3.8*
Average	***21.8***	***48.7***	***27.0***	***6.4***	***1.9***	***–4.5***
Average for 21 OECD countres*	*27.3*	*44.3*	*17.0*	*5.6*	*2.4*	*–3.2*

Sources: Derived from *OECD Historical Statistics* and *OECD Economic Outlook* (various issues).

Note: *Countries for which complete data were available in the sample period include U.S., Japan, Germany, France, Italy, U.K., Canada, Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Netherlands, New Zealand, Norway, Portugal, Spain, and Sweden.

III. EMPIRICAL EVIDENCE ON THE ENVIRONMENT FOR GROWTH

There is considerable evidence illustrating the importance of secure property rights, sound money, competitive markets, openness, and small government in the creation of a healthy environment for economic growth. We will briefly consider some of that evidence.

The Turn Around of Ireland

The experience of Ireland in the last four decades offers a case study in how much difference the right policies can make. During the 1960s and 1970s, the Irish economy was characterized by the growth of government, high taxes, unstable monetary policy and a protectionist trade policy. Measured as a share of GDP, government spending rose from 28 percent in 1960 to 43 percent in 1974 and 52.3 percent in 1986[13]. By the mid 1980s, Ireland was on the verge of collapse. Real growth had fallen sharply. Unemployment soared to more than 17 percent during 1985-87. People were leaving the country in search of opportunity.

Out of desperation, the Irish government began to shift policy. Government spending was sliced, tax rates were lowered, monetary policy became more stable, and trade became more open. Against the backdrop of a decline in its credit rating, government employment was cut by about 10 percent between 1986 and 1989[14]. As Exhibit 8 (top frame) shows, total government outlays fell from 50 percent of GDP in 1986 to less than 40 percent in 1989. They have continued to recede in the 1990s, reaching 33.1 percent of GDP in 1998.

As the size of government declined, taxes were reduced. The top marginal rate imposed on personal income was sliced from 65 percent in 1984 to 58 percent in 1986 to 48 percent in 1992. Most recently, it has been reduced to 46 percent. Corporate tax rates have also been reduced sharply. A more restrictive monetary policy has resulted in persistently low rates of inflation. Lower tariffs following Ireland's entry into the EU boosted the size of the trade sector.

Ireland's change in policy direction led to a remarkable turnaround in the economy. As Exhibit 8 (lower frame) shows, the annual growth rate of real

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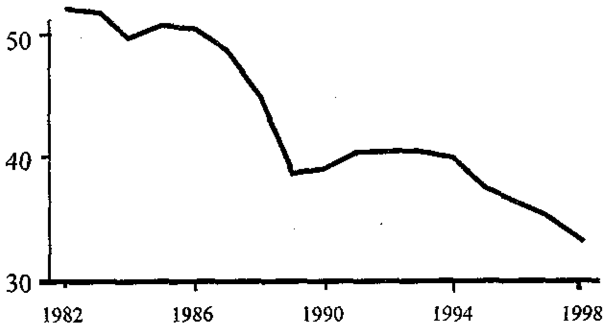
[13] Figures are from *OECD Historical Statistics: 1960-1994* (Paris, Organisation for Economic Co-Operation and Development, 1996), Table 6.5.

[14] Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", *National Bureau of Economic Research Working Paper W5730 (1996)*, p. 25.

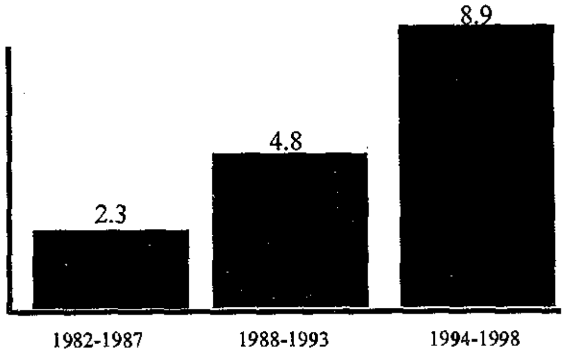
Exhibit 8

GOVERNMENT OUTLAYS AND ECONOMIC GROWTH IN IRELAND, 1982-1998

Outlays as a share of nominal GDP



Average annual real GDP growth (%)

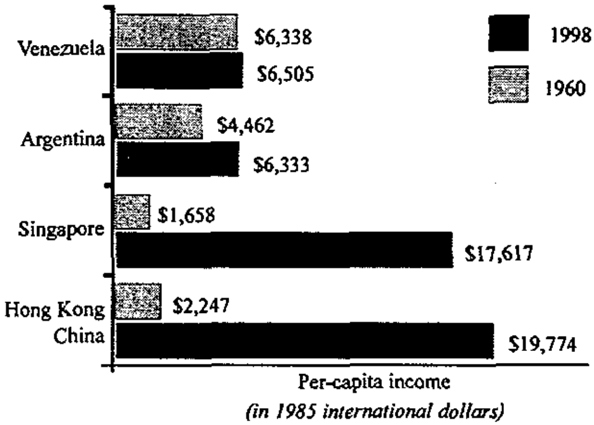


Source: *OECD Economic Outlook, 1999.*

GDP rose from 2.3 percent in 1982-87 to 4.8 percent in 1988-93. From 1994 to 1998 the Irish economy grew 8.9 percent a year. The unemployment rate fell from 17 percent in the late 1980s to 6.6 percent in the late 1990s. Ireland's growth rate has been the strongest by far in Europe during the 1990s. The Irish experiment illustrates the importance of open and competitive markets, small government, low tax rates, and stable monetary policy.

Exhibit 9

THE CHANGE IN PER-CAPITA GDP, HONG KONG & SINGAPORE VERSUS ARGENTINA & VENEZUELA



Source: R. Summers, A. Heston Penn, *World Tables* (Cambridge, National Bureau of Economic Research, 1994). These data were through 1992. They were updated to 1997 by the author.

The Growth Miracles of Hong Kong and Singapore

The experiences of Hong Kong and Singapore also illustrate the importance of sound policies. These two economies are among the most open in the world and, as a result, their trade sectors are quite large. Both have a tradition of rule of law, government expenditures are small as a share of the economy, and taxes are relatively low. The monetary arrangements of both countries have kept the inflation rate under control.

Ratings from the economic freedom indexes developed by the Fraser Institute and the Heritage Foundation provide additional evidence on the quality of the economic environment of these two countries[15]. While the Fraser and Heritage indexes were designed to measure economic freedom, indicators of price stability, the security of property rights, openness of inter-

[15] James Gwartney and Robert Lawson, *Economic Freedom of the World: 2000 Annual Report*, Vancouver, Fraser Institute, 2000 and Gerald O'Driscoll, Jr., Kim Holmes, Melanie Kirkpatrick, *2000 Index of Economic Freedom*, Washington, DC, Heritage Foundation, 2000.

national trade, and size of government formed their core ingredients. During the 1990s, Hong Kong and Singapore ranked 1 or 2 in both of these indexes. The Fraser index has been extended back to 1975. Hong Kong ranked either 1or 2 throughout the 1975-1997 period. Singapore was always ranked in the Top 10 among the more than one hundred countries included in the Fraser project. Thus, the institutions and policies of these two countries have been among the best in the world during the last several decades.

The growth records of these two countries are perhaps the most impressive in the world during the last four decades. Both were relatively poor in 1960. Measured in real 1985 dollars, Hong Kong's per capita GDP in 1960 was $2,247; the figure for Singapore was $1,658. By 1997, Hong Kong's real per capita GDP had risen to $19,774; Singapore's had risen to $17,617. During the 1960-1997 period, the real per capita GDP of Hong Kong rose at an annual rate of 5.9 percent, while that of Singapore rose 6.4 percent annually.

It is interesting to compare the performance of Hong Kong and Singapore with that of Argentina and Venezuela. Even though the latter two countries have an abundance of fertile land and other natural resources, their economies have stagnated. Throughout much of the last four decades, the policies of Argentina and Venezuela have been characterized by monetary expansion, trade barriers, high taxes, and expansion in the size and role of government. The economic freedom ratings of the two South American countries were substantially lower than the ratings for the two Asian countries, particularly during the 1980s. The policies of Argentina and Venezuela undermined the growth process. Their GDP per capita was only slightly higher in 1997 than in 1960. As Exhibit 9 shows, even though the per capita GDP of both Argentina and Venezuela was higher than the figures for Hong Kong and Singapore in 1960, the opposite was the case in 1997.

Economic Freedom and the Environment of Growth

The core ingredients of the economic freedom index of the Fraser Institute are monetary stability, security of property rights, reliance on markets, openness to trade, and a limited scope of government. Thus, it is a measure of the quality of the institutional and policy environment.

A recent study used the Fraser Institute's economic freedom ratings for 1975-1995 to analyze the impact of economic freedom on growth[16]. A cross-sectional analysis of 82 countries found that changes in economic freedom

[16] James D. Gwartney, Robert A. Lawson, and Randall G. Holcombe, "Economic Freedom and the Environment for Economic Growth", *Journal of Institutional and Theoretical Economics*, Vol. 155, No. 4 (December 1999).

exerted a strong and robust impact on economic growth. The positive relationship between economic freedom and growth was present even after differences in human and physical capital were taken into consideration. Furthermore, statistical analysis indicated that the causal relationship ran in only one direction — from increases in economic freedom to more rapid rates of economic growth. This study provides strong evidence that institutional and policy factors are an important determinant of growth.

IV. IMPLICATIONS FOR RUSSIA

Unfortunately, the major ingredients of an environment conducive for economic growth are currently absent in Russia. Property rights are poorly defined and, therefore, often insecure. Settlement of disputes through the legal system is fraught with uncertainty. The monetary arrangements provide little assurance that price stability will be achieved, much less sustained, in the foreseeable future.

In one sense, the central problem of the Russian economy is exceedingly simple. Russia has a large number of enterprises that are continuing to operate even though they are producing obsolete products of little value. These enterprises must be closed and the resources shifted into genuinely productive activities. Given political considerations and the current web of complex barter transactions and implicit subsidies, closure of inefficient enterprises is extremely difficult. In turn, the system breeds political corruption and undermines the growth of honest business activities.

Without the creation of growth sectors, modifying the system and closing the unproductive enterprises is unlikely. Russia must create a healthy climate for the growth of new small and medium size businesses. Three things are critically important in this area. First, a system of land entitlement must be established in order to provide owners with clearly defined property rights. Without this security, owners will be reluctant to develop property. Neither will they be able to use it as collateral in order to raise funds for construction and other business activities. This entitlement process is underway in several cities and regions, but acceleration of this process needs to be a priority.

Second, Russia needs to deregulate business activity. Competition, not regulation, is the disciplining force that directs business toward the service of consumers. Repeatedly, Russians will tell you that it is impossible to operate a business and comply with existing regulations. The regulatory maze strengthens corrupt politicians and criminal elements that use them to extort wealth. Extensive surgery is needed. Except for health and safety, all federal and regional regulations that restrain business entry and operation should be abolished. The required paperwork for entry into business should be cheap, simple, and available at a one-stop location. Other countries have found that this approach works quite well.

Third, the tax system must be simplified and tax rates reduced. The current system reflects the premise that if you tax enough things at high enough rates, the required revenues can be raised. It stifles growth, penalizes honesty, and encourages evasion. Noncompliance is rampant. Given Russia's GDP, the income and wage tax bases are less than half the expected size.

Currently, a 41 percent payroll tax is levied on all wages and salaries. In addition, individuals with modest incomes, even by Russian standards, confront marginal personal income tax rates of 20 percent and above. If there were compliance with the law, these two taxes would take almost 45 percent of the income of the average Russian worker. In particular, the payroll tax needs to be reduced sharply. There is every reason to believe that it could be cut in half (to 20 percent) without an appreciable loss of revenue. A rate cut alone will increase compliance substantially. In addition, however, tax cheats need to be informed that the era of non-compliance is over. With these reforms, the door of business success would also be open to honest citizens.

Of course, other changes would also be helpful. Tariff rates should be reduced and made more uniform. The pension system needs to be reformed and shifted toward a savings and investment structure. Commercial banks need to be separated from the central bank and the central bank should either be replaced by a currency board or given an enforceable mandate to achieve price stability. However, without secure property rights, deregulation of business, and a tax system that makes it possible for honest citizens to compete, other reforms are likely to be ineffective.

Russia now has a window of opportunity to adopt reforms that will create a growth-friendly environment. The economic record of countries ranging from Ireland to Hong Kong to the United States provides valuable insights concerning what works. Hopefully, Russia will profit from these experiences and move boldly toward reforms that will turn the Russian economy around and place it on a path of sustainable growth.

TWELVE PUBLIC POLICIES FOR ECONOMIC GROWTH

Richard K. Vedder
Distinguished Professor of Economics, Ohio University
June 2000

INTRODUCTION[1]

As something of a Russophile who devoured Russian novels and classical music in my youth, I am honored to be asked to offer my observations on the Russian economy. I would note that one century ago an observer of the Russian economy might have noted that Russia had the highest rate of growth of industrial production of any European nation (output had increased 8 percent per year in the 1890s, over doubling in a decade) and was a major recipient of foreign investment.[2] It was in the middle of what Walt W. Rostow termed Russia's "take-off" into sustained economic growth.[3]

An observer 100 years ago might well have expected that over the course of the 20th century, Russia would have converged on the more mature economies of Great Britain, the United States, and Germany, reaching approximate equality with those countries in terms of income per capita. After all, economic theory suggests that, where there is a market economy and free movement of resources,

[1] This paper is an extension of remarks made to members of the presidential administration of Russia in Moscow, April 20, 2000.

[2] On pre-revolutionary growth, see Alexander Gerschenkron, "The Rate of Industrial Growth in Russia since 1885", *Journal of Economic History* 7 (1947), pp. 144-74, especially p. 156. For an older but still useful general discussion of growth in this period, see Harry Schwartz, *Russia's Soviet Economy* (New York, Prentice-Hall, 1954), especially Chapter Two.

[3] Walt W. Rostow, *The Stages of Economic Growth* (Cambridge, U.K., Cambridge University Press, 1960). Rostow dated Russia's take-off to 1890-1914, about the same dates as for Canada. Interestingly, writing in the midst of the Cold War, Rostow concludes that "Russian economic development over the past century is remarkably similar to that of the United States, with a lag of about thirty-five years in the level of industrial output and a lag of about a half-century in *per capita* output in industry" (p. 93). I doubt that he would say that now.

the mobility of labor and capital will work to reduce differences in income disparities between areas. Convergence has worked to give Japan approximate parity with the leading economic powers of 1900, and many poor nations or areas at that time, such as Korea, Taiwan, and Singapore, are affluent nations today. Yet Russia has failed to converge, precisely because it abandoned the moves toward a market economy that it had begun to adopt in the late 19th and early 20th centuries.[4] The last decade has seen the beginnings of a transition from an inefficient command economy toward an economy where the efficiency emanating from market signals can begin to operate. It is the completion of the preconditions necessary for convergence to take place that is essential for economic growth to begin in Russia at a high and relatively sustained level. There is nothing historically inevitable about Russian economic growth, but if 12 preconditions for development cited below are fully met, market forces almost certainly will move to raise the quality of economic life in Russia and lead to it converging on the richer nations to its west and to its east.

No doubt there are political and other obstacles that may prevent instant achievement of the goals outlined below, and as a non-Russian I am very sensitive to the fact that only Russians can make the appropriate decisions that will determine your economic destiny. More than seven decades of Communism led to a decline in self-reliance and a willingness to take risks in Russia. The desire to work hard, save, and invest similarly was depressed. Basic characteristics of competitive capitalism, like striving to improve product quality and pleasing your consumers were not part of the on-the-job training of Russian workers. It takes time to educate workers into the methods of competitive capitalism. It is made even more difficult because arguably Russia *never* has had much experience with market-driven economic change, since, despite the Stolypin reforms after 1907, at the time of the 1917 Revolution, many Russians were farmers still living in somewhat primitive communal conditions that bear little resemblance to the modern market economy. In any case, many members of the older generation that reached adulthood before 1985 or 1990 no doubt are uncomfortable with the risks, uncertainties, and dynamic dimensions inevitable with market-driven economic activity.

Thus, change is difficult, and visionary domestic leadership and possible heavy reliance on foreign physical and human capital investment may be necessary to help inculcate the attitudes and qualities needed for market development. The educational system can possibly help in this regard, although that assumes the existence of instructors versed in an understanding of market pro-

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[4] The importance of market forces in economic growth was not universally appreciated by Western economists during the Soviet era. Some, like Ludwig von Mises, recognized early the impossibility of rational calculations by entrepreneurs in a socialist system. See his *Socialism: An Economic and Sociological Analysis* (trans. J. Kahane, New Haven, Conn., Yale University Press, 1951). Others did not. For example in the 12th edition of his famous textbook, Paul Samuelson (with William Nordhaus) says, "There can be no doubt that the Soviet planning system has been a powerful engine for economic growth." See Paul A. Samuelson and William Nordhaus, *Economics* (New York, McGraw-Hill, 1985), p. 775.

cesses. Nonetheless, as an economic historian, I can share with you my observations based on my study of Western economies of 12 factors that seem to me to be critical for sustained economic development.

TWELVE POLICIES TO PROMOTE ECONOMIC GROWTH

1. Use the power of the state to set "rules of the game" that govern market transactions and provide a legal framework for economic activity. This point includes many dimensions. The ownership of property must be delineated, and government needs to establish a means whereby individuals can clearly demonstrate their ownership of property, be it land, housing, machinery, business enterprises, or financial investments, such as stock ownership in companies. There need to be rules setting out the freedom to enter into contracts with virtually no interference from government. The freedom to make profits without confiscation by either government or private entities needs to be established beyond a shadow of doubt, and written in laws that are enforced by the state. That means a strong police and military apparatus is needed to deal with criminal elements trying to thwart the rule of law. It also means that the courts must be free to make objective decisions without political interference from the government. A strong independent judiciary is vital.

2. In carrying out governmental policies, create a level playing field among various participants in the market economy. When government favors one provider of goods and services or another, it distorts the allocation of resources from what human action dictates based on the desires of consumers and the economic imperatives facing producers. It distorts the signals that markets give out that move resources to their most productive use. Thus, the provision of subsidies to some producers of a product but not to others makes no economic sense. The de-facto levying of differential tax rates on different producers is highly undesirable. The application of regulations to restrict the behavior of some producers (or consumers) rather than others is similarly inappropriate. Such policies not only are "unfair," but they also often prevent potentially successful entrepreneurs from fully exercising the talents that they have. The signals that markets give off that lead to resources moving to their most efficient usage are distorted by government subsidies or unequal taxation. Similarly, unequal treatment of different economic actors reduces the likelihood of foreign investment that is critical to achieving rapid growth and economic convergence.

3. Make labor and capital markets free. Restrictions on the importation of foreign capital reduce resources for growth and raise the specter of discrimination against foreigners that increases perceived investment risks. Requiring detailed registration of individuals before or after moving from one place to another raises the costs of migration. The United States owes a good share of its success to the massive migration of people both internationally and internally. Often output can be increased simply by moving individuals from areas where the productivity of labor is relatively low to areas where, at the margin, new workers significantly increase output and incomes. Rather than subsidize dying industrial cities of the Soviet era, perhaps out-migration from them should be encouraged, and it definitely should be permitted. To be sure, free migration assumes the availability of housing and other things that are not always immediately available in optimal quantities, but the principle of permitting, even encouraging, migration should be established. Housing construction will follow people if profit-maximizing entrepreneurs are allowed to operate in the housing industry.

There is often a temptation to try to emulate the European-style welfare states by imposing all sorts of rules and regulations, particularly in labor markets. I would argue that Western Europe is paying a high price for regulations that impose labor market rigidities, including high rates of unemployment.[5] Although Western Europe can afford the luxury of inefficient regulation, Russia cannot. In particular, it is highly desirable not to impose laws requiring the payment of minimum levels of wages in order to work, or limiting hours of work. Such laws often lead to unemployment among some of the poorest and most disadvantaged members of the population and prevent a fuller utilization of resources. Similarly, laws making it difficult to discharge redundant or unproductive workers reduce incentives for business enterprises to hire workers in the first place. Also, such laws reduce the inflow of capital as well.

4. Reduce government expenditures as a percentage of national output and finance those expenditures through taxation rather than through borrowing, printing money, expropriating private assets, or other means. Although the optimal size of government from the standpoint of maximizing the rate of economic growth varies from economy to economy, there is considerable evidence that most Western industrialized democracies have increased government size beyond the growth maximizing point. In these countries, at the margin incremental expenditures have little positive impact on output, but the incremental taxes needed to finance that spending have significant disincentive effects on human behavior. Excessive marginal tax rates on work activity lead to reduced work, while similar taxes on investments lead to lower levels of capital formation. The financing of government through debt issuance leads to inflation, to loss of investor confidence, to rising nominal and often real interest rates, and sometimes to costly distortions in the real exchange rate. Moreover, it is a form of disguised taxation that fundamentally violates at least one—and perhaps more—principles of financing government.

In relatively poor nations like Russia, the optimal size of government is likely to be smaller than in nations like the United States, France, or Italy. Yet

[5] On this point, see Lowell Gallaway and Richard Vedder, "Unemployment: An International Perspective", *Journal of Labor Research*, Summer 2000.

Russia in 1999 had governmental expenditures of at least 35 percent of total output, higher than the United States. In the United States, I have estimated that governmental size needs to be reduced by 20 to 25 percent or even more to maximize its economic growth, and in Western Europe the governmental downsizing from a growth maximization perspective is even larger.[6] I have not done explicit research on what is optimal for Russia, but based on my other research, I would suspect reduction in expenditures as a percentage of gross domestic product to the 20 to 25 percent range would lead to noticeably higher rates of growth.

To be sure, some government spending probably has more positive or less negative effects than other forms. Spending on infrastructure, for example, may have some positive effects, although perhaps less than if such spending were undertaken by the private sector. On the other hand, from my reading of the evidence for the United States, subsidies, transfer payments, and the like are more likely to have significant negative effects.

In the United States, state-level governments tend to finance virtually all of their expenditures from taxation. There is an enormous body of evidence that shows states with high levels of taxation tend, all other things being equal, to have low levels of economic growth. For example, from 1965 to 1993, the 25 states with the highest average tax burden (as measured as a percentage of personal income), had 60 percent real personal income per capita growth, while the 25 states with the lowest average tax burden had 80 percent growth—one-third more.[7] Al Gore's state of Tennessee had almost exactly the same per capita income as the neighboring state of Kentucky in 1980, but it now has significantly higher per capita income levels. Why? Tennessee had a lower tax burden in 1980 than Kentucky and lowered it still more in the ensuing years. Kentucky, by contrast, raised its overall tax burden. As a consequence, Kentucky's economic growth was noticeably smaller than in its neighbor. This story can be told many times. In 1970, high tax Sweden was by most measures one of the three richest countries in the world. Today, its per capita income is not even in the top 20 countries and is below the average of the original 24 OECD nations.[8] Sweden's tax burden was one of the highest among major nations in 1970 and was raised dramatically after that date, becoming the highest in the Western world.[9] High taxes led to enormous disincentives to work, to save, and to invest.

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[6] See Richard Vedder and Lowell Gallaway, "Government Size and Economic Growth", Study, Joint Economic Committee of Congress (Washington, D.C., December 1998).

[7] See Richard Vedder, "State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform," Study, Joint Economic Committee of Congress (Washington, D.C., December 1995).

[8] World Bank statistics suggest that in 1997, gross national product per capita in Sweden on a purchasing power parity basis ranked 25th in the world; it also was nearly 5 percent below the total OECD and slightly below that for the European Union. See the U.S. Bureau of the Census, *Statistical Abstract of the United States: 1999* (Washington, D.C., Government Printing Office), pp. 841-842.

[9] Taxes as a percent of GDP in 1998 were 63 percent in Sweden, compared with less than 35 percent in the United States and less than 31 percent in Japan. See ibid., p. 847.

5. Adopt a simple tax structure with a small number of broad-based taxes with low rates. There are at least four features that a "good" tax (if there is such a thing) possesses. A good tax is not costly to administer, is neutral in its economic impact, is "fair," and is transparent. Regarding the first point, in the United States, our income tax is extraordinarily complicated, and the cost to society, including the taxpayers who have spent billions of hours complying with the law, is measured perhaps in the hundreds of billions of dollars—a significant percentage of the revenue that the tax raises. That is clearly undesirable.

Taxes that lead to distortion in resource usage are likewise bad. My own research suggests that taxes on consumption tend to have less negative effects on economic growth than do taxes on income.[10] If payroll and individual income taxes for some persons at the margin reach 50 percent or more of income, they likely will have severe disincentive effects, reducing labor supply. In the United States in the early 1980s, when the top marginal tax rate on the federal income tax was reduced from 70 to 50 percent, the number of persons reporting earning more than $1 million in income more than doubled within two years, despite the presence of arguably the worst recession since the Great Depression.[11] Tax reduction led to an unleashing of the entrepreneurial spirit and, for some groups, an actual increase in tax revenues.

In the United States, we have nine states that have virtually no individual income tax (although individuals still must pay the tax levied by the federal government). The other 41 states have such taxes, often reaching rates of about 10 percent of income at the margin for some individuals. From 1990 to 1998, 2.8 million Americans moved from the 41 states with income taxation to the 9 states without such levies. One of the great migrations in human history occurred silently, without press coverage, as people moved away from those governments that seized a significant proportion of the fruits of their productive activities. Several other states are learning from this lesson and are now reducing their income tax burdens. Ireland, with a very low corporate tax burden, is booming as European capital moves to take advantage of low tax rates. Similarly, I have been told that robust growth in Estonia has been fueled in part by a dramatic lowering in top tax rates. Perhaps there are lessons here for Russia.

The tax system should not be used for social engineering in a matter that prevents resources from being allocated on the basis on consumer preferences and the considerations of the cost of production (demand and supply). I have been told, for example, that advertising expenditures are not deductible in calculating income subject to business taxation in Russia. Somehow it is assumed that advertising is wasteful, a notion that is no doubt a holdover from the Soviet era. In fact, advertising is a legitimate business expense, and the information conveyed by advertisements actually helps markets function by leading to more informed buyers of products and services. Advertising strengthens competi-

[10] Vedder, "State and Local Taxation . . .", op. cit.

[11] Richard Vedder and Lowell Gallaway, "Soaking the Rich Through Tax Cuts", *Wall Street Journal*, March 21, 1985.

tion. The tax system should not distort expenditures for this legitimate expense. There are no doubt many other examples.

6. Minimize non-tax restrictions on private economic behavior in the form of regulations. Regulations that restrict entrepreneurs from behaving as they would like sometimes serve a productive social purpose. It makes sense, for example, to prohibit a manufacturer of chemical products from discharging pollutants into a lake that provides drinking water to local residents. At the same time, however, the Western experience is that government officials tend to over-regulate, as they derive power and influence from their regulatory powers. There should be a general rule that "regulation is not permissible unless there is a compelling social need for it." Wage, price, and interest rate controls are particularly bad, as they distort the ability of the price system to serve as a signaling device that efficiently allocates resources.

In the United States, we have found that most new jobs are created by what are initially small businesses. The most dynamic and valued companies in the United States include many founded as small businesses in the past two or three decades, including Microsoft and all the dot-com corporations. The proportion of the U.S. workforce employed by the 500 companies on the *Fortune* magazine list of largest corporations has declined by about one-half over the past one-third century. Thus, it is critically important to minimize restrictions on starting new businesses. Business permits or registration should be simplified, perhaps to initiating a "one-stop" approach whereby a would-be entrepreneur can quickly and cheaply receive the necessary permission to enter business. Conceptually, the question needs to be asked: why does a person need *any* permission to begin a business? If Russia is going to make mistakes in this area, a good case can be made that it should err in the direction of too little regulation, as regulation tends to reduce the ability for entrepreneurial talents to be manifested.

In general, the principle should be established that regulation is permissible only where there is compelling evidence that the expected present value of the future benefits of the regulation exceed the present value of the expected costs. The evaluation of costs and benefits must be done by some agency other than the one formulating or enforcing the regulation. In short, the regulators must be regulated.

Regulation extends to the international sphere as well. Pressure will be placed on Russia to sign international agreements that regulate the environment or the workplace, for example. Often these agreements are pushed by politicians without a clear understanding of the true benefits or costs, such is the case with the Kyoto accords. Although Western nations have the luxury of being able to impose costly regulation on their citizens, the burden of doing so in Russia is potentially far greater given lower initial levels of per capita income. In their earlier stages of development, nations like the United States and Great Britain largely had unregulated economies, and the entrepreneurial freedom that resulted had profoundly positive long-term economic effects. Do not give up that freedom. You need to be realistic and scientific in assessing costs and benefits before signing international agreements or implementing domestic regulations that constrain entrepreneurial freedom to engage in economic activity.

7. Continue to privatize state economic activities. Privatization by itself is no panacea, and it should be done in a way that ensures competition and market activity, not monopolies and state subsidies. Nonetheless, on average, enterprises that compete in a market economy face a discipline that government-owned or -controlled businesses do not, leading to higher productivity and efficiency. It would seem to me that large government monopolies, like the gas and electric companies and the railroads, should be candidates for privatization and that, at the minimum, they should be subject to competition (accomplished by dividing the existing companies by function, such as production and distribution, by geographic area, or by both). The last point is important. Much of the relative efficiency of private enterprise compared to governmental ventures comes from competition. Privatization must be undertaken in an environment of competition, with the state showing no favoritism toward any enterprise.

8. Strengthen the banking system and stabilize the currency. Turning first to the latter point, a large-scale monetization of governmental expenditures is extremely unproductive, lowering the confidence of foreign investors, causing capital outflows, etc. Russian learned this lesson in 1998. The long-term correlation between economic growth and both the level of inflation and its volatility appears to be negative. The stabilization of prices must be a key goal in the restoration of confidence. The fashionable Keynesian notions that inflation can reduce unemployment and stimulate the economy have been demolished by the experience of the past generation. The price system is an information device, and inflation distorts the operation of price signals and sometimes sends the wrong information to entrepreneurs. Inflation imposes a cruel and capricious tax on some members of the citizenry as well.

In some situations, the pursuit of monetary stability suggests that fundamental reform of institutional structures is necessary. This is particularly true where the political will to restrain monetary expansion is lacking. Alternative approaches include adopting a commodity (e.g., gold) standard, creating a currency board, joining an economic union (such as the European Union) or adopting the currency of another nation (not necessarily the United States). Given the experience of the past decade, it may be wise to explore one of these options. I believe it is less important which approach is selected than it is to establish credibility in the medium of exchange both domestically and internationally. Should the Bank of Russia or other institutions prove unwilling or unable to establish that credibility, alternative approaches to monetary stabilization need to be explored.

Russia needs good, sound, well-capitalized, and trusted banks. Given the limited Russian experience with for-profit private commercial banking, it makes sense to invite foreign interests to participate more freely in the banking system. Although it is understandable to worry about excessive foreign control, rules limiting the foreign role to 12 percent seem to be counterproductive. Increased bank competition in the long run leads to reductions in the net interest margin of banks, meaning relatively higher rates of interest for bank depositors and lower interest rates to lenders. Other things equal, this should lead to increases in domestic savings and investment. It was the falling cost of bringing together savers and investors that contributed importantly to a roughly five-fold growth in the domestic savings rate in the U.S. economy during the 19th century, for example, and replication of that experience in Russia would almost certainly pay dividends in the long run.

A critical dimension in monetizing the economy where fractional reserve banking exists is the development of trust. In some cases, this can be enhanced by credible bank regulation and/or by the adoption of deposit insurance. The central bank, if it is to exist (which it might not under, say, a currency board), should have a narrow, focused role of maintaining the soundness of the currency. The inherent conflict of interest implicit in a system where the central bank regulates other banks but also has some financial interest in one or more of them is highly undesirable.

9. Reform laws and regulations relating to corporations along Western lines. Although excessive government regulation of corporation governance is clearly undesirable, some "rules of the game" need to be established centrally. For example, it is not unreasonable to require companies that have many shareholders to follow certain uniform procedures in reporting their financial condition to their owners. Accounting standards need to be uniform and, ideally, should not deviate significantly from European or U.S. practice in order to increase foreign investor confidence. If rules on, say, the depreciation of assets or amortizing "good will" vary dramatically from Western practice, the ability to secure foreign capital may be severely impaired. Given Russia's default on some debt obligations and the subsequent flight of foreign capital, this is a matter of some importance.

In the United States' formative years in the 19th century, many corporate abuses occurred that impaired somewhat the development of the economy by slowing private investor support of equity markets. Reports indicate similar problems occurring in contemporary Russia. Government should not meddle in the internal affairs of corporations or joint stock companies as a rule; nonetheless, it can play a constructive role in determining the "rules of the game" for the operation of corporate democracy. It is particularly important to protect the rights of minority stockholders or "outsiders" from abusive practices of a controlling stockholder or inside management. To cite one example of a desirable practice, compensation of management should be transparent and set by boards of directors that include stockholders outside the immediate management of the firm. Failure to comply with laws requiring these practices should be punishable by severe sanctions, including prison terms and large fines.

Obviously, not only do laws have to be established but also a significant enforcement mechanism needs to be established.

10. Rationalize the social security system and its financing. Russia is not alone among nations facing serious problems with its pension system for older citizens. Yet Russia's system provides extremely small pensions for a large number of recipients, financed by very high payroll taxes, where the combined employer-employee tax reaches 41 percent of wages, a rate that induces profound disincentive effects and encourages inefficient non-cash economic activity.

Although well-to-do Western economies all have pension systems for the elderly, can Russia afford such a system at its stage of development? Might economic justice and security be better served by having a means-tested system, whereby individuals who are truly poor might receive even larger pensions than at present, but individuals who have some wealth or whose children are prosperous will not be eligible for benefits? The wealthiest nation in the world, the United States, offers benefits only at the age of 62, with full benefits coming at 65, an age that is being raised over time to 67. It feels it cannot afford to let people retire at 55 or 60. If the United States cannot afford it, how can Russia? Given the low income levels and the need to expand output, pension inducements that lead to reduced labor force participation among often productive individuals in their 50s or 60s seem extremely costly. Perhaps the retirement age could be raised by, say, by an average of six months per year over the next decade or two, also equalizing the retirement age for males and females gradually (this can be achieved by raising the retirement age of females more per year than males).

As to financing, strong consideration should be given to moving to a partial or complete privatization of the system, learning from the model of Chile and other nations. It is important that individuals "own" their investments, with the value reported to them on a timely basis. Such a system would increase individual responsibility, largely end the politicization of the investment decision-making process, lead to probable higher investment returns, and possibly have other advantages. Given the inexperience of the average Russian citizen in equity markets, perhaps the appropriate initial approach would be to allow competing private investment firms to offer alternative portfolios, including different types of mutual funds. Individuals would select the firm they want and have the opportunity to change periodically.

11. Move toward free trade. The convergence of incomes between poor and rich areas depends critically on the free mobility of goods, services, persons, capital, and ideas from one geographic area to another. Although some of the barriers to mobility are natural, determined by transportation costs, and others are related to anti-investor laws, taxes, regulations, etc., some are simply the product of tariffs and other direct barriers to trade. Other things being equal, when artificial barriers to trade are reduced, trade volume increases and, with that, economic welfare. On this point, there is nearly universal agreement among professional economists.

It is true that tariffs provide needed governmental revenues and that they are generally a reasonable form of taxation from the standpoint of administrative costs and equity. Accordingly, for these and other reasons it may be appropriate to reduce tariff and other barriers over time, perhaps in connection with international agreements where reciprocity is shown by other nations. Tariff reduction usually serves to promote productivity advances internally, as the increased foreign competition fosters greater moves toward efficiency among domestic producers.

The move to free (or freer) trade also implies the removal of any barriers to the acquisition of foreign exchange or the free movement of capital. Capital flows must be unimpeded in either direction. Open product and resource markets promote economic growth, even if they may temporarily pose problems for protected domestic interests.

12. Rationalize your intergovernmental fiscal relations. Like the United States and Germany, Russia has a federated system of government, with 89 different regional governments providing local services. Such a system, if used appropriately, can promote some efficiency and competition in government, and can provide information useful in assessing the effectiveness of governmental policies. In the United States, for example, relatively little funding goes from Washington to the state capitals to finance local and state governmental activity. States must raise their own funds, meaning local politicians are accountable to local voters for their actions. Wasteful government expenditures are somewhat reduced from what would exist if a large proportion of state revenues came from Washington. To an increasing extent, states engage in tax competition, knowing that businesses and productive individuals will abandon those states that impose high taxes. Thus, governments are less able to operate like monopolists charging high "prices" (taxes, in this case) than where this federalist phenomenon is absent. This reduces somewhat the inherent inefficiencies of the public sector.

In Russia, the move to a federalist system is still somewhat new, and difficulties remain in relations between the central government and regional ones. The trick is to maintain central control and dominance over certain obvious national functions—the provision of defense and the implementation of monetary and foreign policy, for example—while at the same time promote experimentation and competition among the regions in providing other services, such as education and roads.

CONCLUSIONS: CONVERGING ON CONVERGENCE

Where markets are free, the rule of law is strong, the currency is sound, and taxes and regulation of private entrepreneurial activity are minimal, resources will tend to move in a manner that will enhance economic welfare. Poorer nations will converge on richer ones. Thus, Japan in the 20th century completely closed the gap separating its economic performance from that of the United States and Western Europe. The same experience has been replicated throughout much of southeast Asia, with Taiwan, Hong Kong, South Korea, Singapore, and Malaysia being good examples. China is the largest example of a nation that has moved with considerable success toward the development of a vibrant market capitalism, and India increasingly is freeing businesses from the shackles that have constrained the entrepreneurial spirit in that vast land. Similar developments are happening in some other places in the world as well, notably Latin America. However, where markets are repressed, such as in North Korea, divergence replaces convergence as the economic norm.

Attitudes cannot be changed overnight, and bureaucratic, political, and institutional obstacles to needed reform are no doubt substantial in Russia. A different (i.e., more recent capitalist experience) historical background that has permitted a faster transition in, say, Hungary and Poland is not present in Russia. Yet Russia has a well-educated populace and vast natural resources. It has demonstrated enormous creativity over the centuries in literature, music, science, and engineering. Those creative talents can be harnessed to promote economic change. Given the right environment, the latent entrepreneurial talents of Russian workers and capitalists will provide the resources for enhanced levels of income and output. The transition has not been easy, nor is it over. Yet with appropriate public policies to set the groundwork, the people of Russia can exercise their talents in the marketplaces of the world in a manner that will provide them with the affluence that they deserve and restore a nation to the greatness to which it historically has aspired.

THE POLITICS OF SUCCESSFUL STRUCTURAL REFORM

Sir Roger Douglas

OECD studies show that politicians tend, world-wide, to avoid structural reform until it is forced upon them by economic stagnation, a collapse of their currency or some other costly economic and social disaster.

Politicians tend to close their minds as long as they can to the need for structural reform, because they believe that decisive action must inevitably bring political calamity upon the Government.

As their country's economy drifts closer to crisis and structural problems are no longer deniable, they persuade themselves that action within a relatively short time of an election would give the advantage to their political opponents.

They convince themselves that this stance is justified by pretending that the opponents are deceitful and interested only in their own gain, not the country's well-being.

When the economic situation is serious enough to arouse public concern, in many cases, both parties may seek to evade the issue by offering electoral bribes to distract voters from the real problems.

I intend to argue the contrary case: That political survival depends on making quality decisions; compromised policies lead to voter dissatisfaction; letting things drift is political suicide.

My aim is to show that politicians can take practical steps and politically successful action to benefit the nation, without waiting until economic or social disaster has forced their hand.

It is not my intention to argue that in New Zealand we got everything right after 1984.

However, what I will argue is that where we implemented quality policies in that period, the polls show ongoing voter approval. Wherever we stopped short of quality, the polls show rising disapproval from the public.

THE CENTRAL STRATEGIC CONSIDERATION IS THEREFORE, THAT

Quality decisions are the key to structural reform and to political success in government.

The evidence of New Zealand's story is plain. The politicians who sought success through ad hoc solutions, which evaded the real problems, damaged the nation and destroyed their own reputations.

Voters ultimately place a higher value on enhancing their medium-term prospects than on action that looks successful short-term, but only by sacrificing larger and more enduring future gains.

A fundamental choice is always there: You can take the costs up-front for larger medium-term gains; or focus on short-run satisfaction and be sandbagged later by the accumulated costs.

Those concepts are not foreign to the public. People accept low incomes as students to earn more later. They save for their old age, and willingly invest in a better future for their children.

There is a deep well of realism and common sense among the ordinary people of the community. They want politicians to have guts and vision to deliver sustainable gains in living standard.

Inadequate politicians see instant popularity as the key to power. If their rating slips, they feel threatened. They look for policies with instant appeal to create continuous public bliss.

That approach flies in the face of reality. There is no free lunch. Every decision involves trade-offs, which do not vanish just because some politician chooses to ignore them.

The sordid fact is: instant solutions do not have instant popular appeal. Notoriously, they are peddled by politicians who actively blind themselves and others to the facts about the situation.

The problem with compromise policies is simple. They do not produce the right outcome for the public at the end of the day. So they come back to haunt the politicians responsible for them.

As costs and distortions accumulate, such Governments resort to misrepresenting and suppressing vital information about future economic prospects, to warp the judgement of the voting public.

Too often, they end up locking themselves and the public into their own nonsense. No one escapes until a crash has liberated the suppressed information, and consigned them to oblivion.

Going for quality means choosing the actions that deliver most benefit to the nation in the medium term, instead of choosing more now, for supposed political gain, at the cost of less later.

Objectives set on that basis, and the means most likely to achieve them, must both be tested against the best available economic analysis and against all of the available evidence.

Traditional preconceptions or prejudices about means should not be allowed to prevent a thorough review of all options, and the selection of the means most likely to achieve the chosen goals.

From my view point, it makes political sense to act from day one on the following basis —

If a decision makes sense in the medium-term, go the whole hog for quality solutions. Nothing else delivers an outcome that will satisfy the public at the end of the day.

What then was New Zealand's response to quality politicians?

Wherever the New Zealand Government implemented uncompromised quality policies since 1984, the opinion polls show that voters today give a satisfactory rating to the Government's performance.

Wherever the New Zealand Government did not or has not gone the whole way for quality decisions since 1984, government approval rating is always low.

LESSONS OF NEW ZEALAND EXPERIENCE

New Zealand's experience provides an important insight into the nature of political consensus, which is widely misunderstood by politicians here and around the world.

The conventional view is that consensus support must exist for reform before you start otherwise the actions taken will not prove to be politically sustainable at election time.

The tendency is to seek consensus in advance by compromising the quality of the decisions to bring the benefits up-front and either ignore any costs or push them further down the track.

But when the Government compromises its decisions for immediate advantage at the expense of the medium-term outcome, the dissatisfaction of the public will intensify over time.

The fact of the matter is that the interests of the various groups in society are complex and diverse. None of them welcome the idea that their traditional privileges may be removed.

Consensus then for quality decisions does not arise before they are made and implemented. It develops progressively after they are taken, as they deliver satisfactory outcomes to the public.

To win elections consistently, governments need the guts to implement quality decisions, take the pain up-front instead of postponing it, and be judged on the basis of the good outcomes they deliver.

By taking that approach, Labour won an increased majority in 1987. To the extent that we have continued to take it since then, we kept open an opportunity to win again in 1990.

On the other hand, to the extent such a government loses the nerve required to take a consistent, medium-term approach to quality, the result of the next election will become doubtful.

What then is the required recipe for using quality policies to combine successful structural reform with electoral success?

Ten key principles should underlay any strategy.

1. Quality decisions start with quality people
2. Implement reform by way of quantum leaps
3. Speed is essential
4. Once you start the momentum rolling, never let it stop
5. Credibility is crucial
6. The dog must see the rabbit
7. Stop selling the public short
8. Don't blink or wobble
9. Use opportunity, incentive and choice to mobilise the energy of the people
10. Elect politicians who have the guts to undertake structural reform

My remaining comments are about those 10 principles, illustrated by example when I have the time.

PRINCIPLE NO. 1
Quality decisions start with quality people

Policy starts with people. It emerges from the quality of their observations, knowledge, analysis, imagination and ability to think laterally to develop a winder range of options.

The quality of the Labour Government's policies in New Zealand of which I was a member was made possible only by the fact that Labour was lucky enough to attract capable new candidates in 1978, 1981 and 1984.

They shared Labour's traditional goals, were able to get their minds around complex issues, cared about getting the outcomes right and had the guts to adopt means that would achieve them — means that had not been traditionally supported by Labour governments.

The success of our public sector reforms since 1984 depended on people as much as policy. Replacing people who cannot or will not adapt to the new environment is pivotally important.

Getting the incentives and the structure right can also transform the performance of many dynamic and capable people who were not able to achieve the right results under the old system.

In the private sector also, management quality has improved dramatically since deregulation.

The change in the Business Roundtable (NZ top 40 companies) membership is typical — 31 of the 40 people who were members in 1985 had changed by 1988. The average age of Roundtable members has dropped by 10 years.

The biggest quality problem to emerge over the last 6 years in New Zealand by far, is the calibre of the people attracted to and selected for political candidacy in both the Labour and National Parties.

The main risk to the policies put in place in New Zealand over the last 7 years arises from both parties' inability to recruit good people currently.

A solution can only occur if enough people with guts, education and vision are willing to accept the tasks involved in doing something worthwhile for their country in the political area.

The low status of politicians in the community is a chicken-and-egg problem. It results from the short-sighted, excessively partisan approach so many of them take to their responsibilities.

The fastest and the best way to transform the present status problem facing politicians is for a world-wide influx of quality people to enter government.

I think it is particularly appropriate to make such points to this audience. Politics is a mess because too many quality people are content to criticise from the sidelines.

As long as that situation persists, we will wait in vain for good government in democratic countries. Improvement will occur only if quality people take the trouble to get themselves involved.

By placing quality at the heart of all our endeavours, we break the old moulds, which have discredited politics and politicians and led too many countries into avoidable economic calamity.

PRINCIPLE NO. 2
Implement reform by way of quantum leaps using large packages

Do not try to advance a step at a time. Define your objectives clearly and move towards them by quantum leaps. Otherwise the interest groups will have time to mobilise and drag you down.

In New Zealand and world-wide, the conventional perception is that reformers are playing against a stacked deck of cards. Genuine structural reform is portrayed as equivalent to political suicide.

That rule holds good where privileges are removed one at a time in a step-by-step programme. Paradoxically, it ceases to apply when the privileges of many groups are removed in one package.

In that case, individual groups lose their own privileges, but simultaneously, the aggregate cost of paying for the privileges of all of the other groups in the economy is removed from them.

Paradoxically, it is harder to complain about damages to your own group when everyone else is suffering at least as much and you benefit from their loss, in the medium-term.

The underlying fact is that, whatever their own losses, each individual group also had a vested interest in the success of the reforms being imposed on all of the other groups.

Packaging reforms up into large bundles is not just a gimmick. Its political and economic efficiency rests on fundamental considerations, which are the essence of good structural reform:

The economy operates as an organic whole, not an unrelated collection of bits and pieces. Structural reform aims to improve the quality of the interactions within the whole.

When reform is packaged in large bundles, the linkages in the system can be used to see that each action effectively enhances every action and also improves its selling potential.

Winning public acceptance depends crucially on demonstrating that you are improving the opportunities for people as a whole, while protecting the most vulnerable groups in the community.

Large packages provide the flexibility needed to demonstrate that the losses suffered by a group of people are offset by fundamental gains for the same group in some other area.

The public will take short-term pain on the chin, if the gains are spelt out convincingly, and the costs and benefits have been shared with visible fairness across the community as a whole.

PRINCIPLE NO. 3
Speed is essential — it is impossible to go too fast

Speed is essential and it is impossible to go too fast. Even at maximum speed, the total programme will take some years to implement. The short-term trade-off costs start from day one.

When reform has been delayed for many years, the trade-off costs are inevitably considerable. Tangible benefits take time to become visible, because of the lags built into the system.

If action is not taken fast enough, the consensus that supports reform can collapse before the results become evident, while the Government is still only part-way through its reform programme.

Vested interests seeking to preserve past privileges will always argue strongly for a slower pace of change. It gives them more time to mobilise public opinion against the reforms.

On the other hand, vested interests cannot obtain the pay-off from change until the government has moved far enough to reduce the costs imposed on them by the privileges of other interests.

The vested interests continuously underestimate their own ability to adjust successfully in an environment where the Government is rapidly removing privilege across a wide front.

They focused on symptoms, not fundamentals at every stage.

Many apparent demands for a slower pace, on closer analysis, express a powerful resentment that the Government is not moving fast enough to abolish privileges enjoyed by rival groups.

Farmers in New Zealand who lost direct subsidies equivalent to 35c in every dollar they earned and because of a strengthening New Zealand dollar, received less New Zealand dollars for what they sold, survived because action was taken in New Zealand to reduce excessive protection elsewhere.

e.g. Tariff reduced
Railways restructured
Ports etc.

It is uncertainty, not speed that endangers the success of structural reform programmes. Speed is an essential ingredient in keeping uncertainty down to the lowest achievable level.

When state trading departments were being transformed into commercial corporations, it became obvious that large-scale redundancies would occur in the coal and forestry areas.

Because some of those activities were located in depressed areas, the Government took its time to make the final decision, leaving thousands of employees in limbo for about six months.

Staff knew that some of them had no future in the industry, but did not know who. They could not leave before the Government made up its mind, because they might lose their redundancy payout.

The result was deep and intense bitterness, which the Government interpreted as being, directed primarily against the policies themselves. It further eroded the willingness to take action.

Once firm decisions were announced, the feeling in those regions improved rapidly. A lot of those people always knew change was inevitable. The public often shows more realism than politicians.

What those people really wanted was an end to the uncertainty, so that they could decide how to get on with their own lives.

A great deal of technical debate has been aired world-wide about the optimum sequencing of structural reform, and the alleged sequencing errors of governments, both here and elsewhere.

My view is that these debates are largely irrelevant in practice.

Before you can plan your perfect move in the perfect way at the perfect time, the situation has already changed anyway. Instead of a perfect result, you wind up with a missed opportunity.

Some decisions take full effect the day they are made. Others take years of hard work before they can be fully implemented. Perfect sequencing, even if it existed, would not be achievable.

If a window of opportunity opens up for a decision or action that makes sense in the medium term, use it before the window closes.

When an economy has been driven down a blind alley and ends up facing a brick wall, what matters is to back it out as soon as possible and get it back on the high road to a better future.

PRINCIPLE NO. 4
Once you start the momentum rolling, never let it stop

Once you start the momentum rolling, never let it stop until you have completed the total programme. The fire of opponents is much less accurate if they have to shoot at a rapidly moving target. If you take your next decision while they are still struggling to mobilise against the last one, you will continually capture the high ground of national interest and force them to fight uphill.

The Government can develop public awareness of the key issues by structuring the content and sequence of its packages to dramatise the relevance of the fundamental economic linkages.

The underlying process of structural change is very important.

Before you remove the privileges of a protected sector it will tend to see structural changes as a threat which has to be opposed at all costs.

After you remove its privileges and demonstrate that the clock cannot be turned back, the group starts to focus on removing the privileges of other groups that still boost it own costs.

On the other hand, exactly the opposite process occurs wherever some favoured group is allowed to retain its privileges, and given ongoing protection from the broad thrust of the reforms.

Anxiety levels in protected groups rise steadily as reform progresses in the rest of the economy. They fear their turn may come next. Their internal organisation improves dramatically.

They boost their public profile. They entrench their opposition to conceal their vested interest in exemption from reform. They will aim to dictate the rhetoric that governs all public debate.

In New Zealand, for example, reforms designed to reduce waste and inefficiency across the widest possible front were consistently painted as adherence to the nastiest form of hard-line monetarism.

Commercialisation, designed to achieve more jobs and better living standards for everyone, was said to be driven by an uncaring New Right obsession with profit at the expense of people or service.

Efforts to improve the quality or quantity of health services for ordinary New Zealanders were portrayed as replacing public care with private profit at the expense of the ill and the elderly.

The strategy of this rhetoric is to obliterate public awareness of all medium-term benefits, exaggerate the short-term costs and portray these costs as the objective or sole outcome of reforms.

These groups end up making strenuous efforts to gain control of the political process in the reforming party to stalemate any threat to themselves by terminating the total reform programme.

THE ANSWER IS: STOP THE ROT BEFORE IT BEGINS. REMOVE PRIVILEGE EVEN-HANDEDLY ACROSS THE BOARD AND GIVE SUCH GROUPS, ALONG WITH EVERYONE ELSE, A MORE CONSTRUCTIVE ROLE IN A BETTER SOCIETY.

PRINCIPLE NO. 5
Credibility is crucial

Continuous credibility is essential to maintain public confidence in structural reform and minimise the costs. The key to credibility is consistency of policy and communications.

The voting public has seen governments come and go, all of them promising low inflation, more jobs and higher living standards. But for year, life has gone on exactly as it always used to.

Take the first step early and make it a big one. You have to break the pattern of the past dramatically enough to convince the community that, this time, somebody really does mean business.

When the government lacks credibility, people refuse to change until the clash between their old behaviour and the new policy imperatives has imposed large, avoidable costs on the economy.

As the reform programme rolls forward, a lot of people start hurting. Their confidence depends on maintaining the conviction that the government will drive reform to a successful conclusion.

Speed, momentum, the avoidance of ad hoc decisions and an unwavering consistency in serving medium-term objectives are the crucial ingredients in establishing the government's credibility.

You know when you start to win the credibility battle. The media begin to put every government statement under a microscope, looking for inconsistent decisions and lapses of principles.

People begin to grasp the idea that wherever a group manages to hold on to privilege and protection, an avoidable cost is imposed on those who are facing up to the adjustment process.

At this point — the message from the voting public changes. It now reads:

Keep the reform process going – drive it to a successful conclusion or you are dead in the water at the next election.

Structural reform has its own internal logic, based on the linkages within the economy. One step inevitably requires and leads to another, to extract benefit for the nation as a whole.

Abolishing export assistance is fruitless, unless the costs of exporters are also reduced by lowering tariffs, deregulating internal transport and reforming ports and shipping services.

The fiscal gains from corporatisation or privatisation will vanish without trace of expenditure if an unreformed social services sector is left to rise without regards for efficiency.

The redundancies created as production is rationalised to improve efficiency may turn into more or less permanent unemployment if an inflexible labour market protects insiders against outsiders.

Where the logic of reform is not followed closely enough, the confidence of investors will be impaired and the ultimate sustainable growth rate achieved may be less than optimal.

Credibility takes a long time to win but it can be lost almost overnight. Confidence then collapses. The costs of the adjustment rise. The time required expands. The political risk increases.

The battle for consistency and credibility is always ongoing and never finally won. It remains permanently central to every decision that comes before the government for consideration.

In the wake of the sharemarket crash of 1987, for example, many countries sought to soften the political and financial impact on the community by easing back on their monetary policies.

The dragon of inflation leapt back to life. Those countries were then faced with the costs involved in slaying it for the second time. Electors do not thank you for that.

Winning back lost credibility can take longer than winning it in the first place. If confidence starts to waver, push the reform programme forward a big new step — and take it quickly.

PRINCIPLE NO. 6
The dog must see the rabbit

People cannot co-operate with the reform process unless they know where you are heading.

Go as fast as you can but where practicable, give them notice by seeing out your objectives and intentions in advance.

Where programmes can or will be implemented in stages over time, publish the timetable up-front.

Those strategies show that you know where you are going, commit the government to the action, let people know how fast they have to adjust and reinforce the credibility of the total programme.

Decision makers must be able to see as much as possible of the total pattern of change affecting their businesses in the period ahead of them in order to plan an effective adjustment.

The release of information also places professional analysts throughout the community in a position to make their own independent evaluation of progress and government performance.

They understand the importance of quality in decision-making and the benefits available via consistent medium-term policies. They are often trusted advisors of the interest groups.

Over time, their objectivity, combined with their increasing goodwill towards the reform programme, becomes one of the major factors in creating a favourable climate of public opinion.

The confidence of the community is further increased if private sector people respected for their experience and capability are involved in helping to fine-tune policies and improve management.

In New Zealand, expert panels appointed from the private sector for example, received public submissions on our major tax initiatives to help remove any administrative bugs from the new systems.

Conventional political wisdom says that structural reform, because it imposes short-term costs, which are unwelcome to the public, is a recipe for political suicide at the next election.

In 1987, after the most radical structural reform in New Zealand for 50 years, which e.g. saw mortgage interest rates rise from 11 percent to over 20 percent, Labour fought the election on a platform that the job was only half done — and that we alone had the guts and know how to finish it.

The government was returned with all the seats it won on the landslide 1984 election and took two more seats away from the opposition. Voters wanted the job completed and done right.

Credibility and consistency can be maintained only in the context of a disciplined Cabinet which works right through the issues and stands four-square behind every decision collectively taken.

If the discipline of collective Cabinet decision making and collective Cabinet responsibility breaks down as it did in New Zealand in 1988, the way is open for interest groups to seek to regain control of the ballgame and the government loses its credibility and the next election as we did in New Zealand in 1990.

PRINCIPLE NO. 7
Never fall into the trap of selling the public short

Do not mistake the fears of the politicians for ignorance, lack of guts or lack of realism on the part of the voting public.

The people out there in the community fight wars when they have to. They trade off short-term costs for long-term benefits every day of their life. They take out mortgages and bring up children.

Faced with the need for structural reform, normally responsible politicians will confide privately: "I know it's needed, but people out there don't know! Politics is the art of the possible!"

Middle-of-the-road MPs maintain their personal security by making sure that their grip on reality is fuzzy round the edges: "Ups and downs are normal. Things will come right. They always do."

As the problems worsen, the demagogues and opportunists move in: "We have just one problem — our political opponents are nuts! I can fix the lot with applied common sense and some No. 8 wire."

For years at a time, while the economy drifts on towards crisis or collapse, the public is offered nothing better than that, by way of information or diagnosis. So they give the demagogue a go.

Nobody stops to think that what people may really want is politicians with the vision and the guts to help them to create a better country for their children in the year 2000 and beyond it.

Successful structural reform does not become possible until you trust, respect and inform the electors. You have to put them in a position to make sound judgements about what is going on.

Tell the public and never stop telling them right up-front:

✓ What the problem is and how it arose
✓ What damage it is doing to their own personal interests
✓ What your own objectives are in tackling it
✓ How you intend to achieve those objectives
✓ What the costs and the benefits of the action will be
✓ Why your approach will work better than the other options

Ordinary people may not understand the situation in all its technical detail but they have a lifetime of experience at work and at home to help them sift the wheat from the chaff.

They know when the key questions are being evaded. They can sense when they are being patronised or conned and do not like it. They respect people who front up honestly to their questions.

PRINCIPLE NO. 8
Don't blink: public confidence rests on your composure

Structural reform in New Zealand involved Ministers in making some of the most radical decisions announced to the public for 50 years or so.

Relaxed, matter-of-fact composure is essential every time you face the public. Their confidence is always based on yours.

As the pressure of change comes on to the economy, the whole community starts watching every television appearance like a hawk, looking for the least twitch of government nervousness.

Their confidence in and co-operation with the reform programme can be undermined by the least blink. Visible uncertainty among key Ministers spreads like a plague throughout the community.

Structural reform demands a major change in the ideas and attitudes which ordinary people grew up with. Such demands inevitably cause discomfort and uncertainty in many people.

Our qualitative research showed that, in the process, people become hypersensitive to any signs of similar anxiety in the politicians who are responsible for the reform programme.

They attend meetings and watch the TV news not just to find out what is happening and understand the ideas behind it but also to probe the feelings and emotions of the people at the helm.

When they cannot understand the technical detail of the argument, they rely on their own assessment of the speaker's mental and emotional condition to provide them with a basis for judgement.

That is another reason why it pays to make decisions of the finest quality. When you know you got it right and know the policies are on course that comes out through their TV sets.

TVNZ told me they searched their film library for a clip of Roger Douglas looking nervous or uncertain and were disgusted to find that I looked "cheerful and relaxed the whole bloody time".

Knowing or believing that you have got it right provides a firm foundation for dealing with people in a relaxed, confident way when you are face to face with them, even at large meetings of quite angry people.

These remarks are not a recipe for arrogance. Listening to argument from sources of every kind is as fundamentally important to policy-making, as well as to selling policies successfully.

But, all of that advice has to be measured against the Government's medium-term goals. It is not arrogance to hold a sound course towards objectives that benefit the country.

PRINCIPLE NO. 9
Incentives, choice, monopoly: Get the fundamentals right

A sick economy cannot be regulated back into health. Economic dynamism is the liberated energy of people at every level personally choosing and using opportunities that benefit them.

Government's role is to create a framework that widens their opportunities for choice, improves the incentives to productive activity and sees that their gain benefits society as a whole.

In other words **Politicians need to remember whose side they are on.** Interest groups whether of farmers, manufacturers, teachers or health workers — exist to serve the interests and improve the lives of consumers.

The purpose of economic activity is to satisfy the needs of consumers. Government is not there to protect vested interests at the expense of the consuming public.

Its role is to ensure that vested interests cannot thrive except by serving the general public effectively.

In command economies, the theory was that such problems would disappear if governments took the power to make all the important decisions on behalf of the general public, to protect people.

Since 1917 that theory has been tested to extinction. The power they used was taken away from the people themselves. Government became the most oppressive vested interest of all.

In New Zealand, the government, by its past domination of areas like coal-mining, electricity, education, health and welfare has often gone quite a long way in that direction.

Our attention was focused on the benefits of regulation, without regard for the wider costs imposed. On that false accounting, regulation will seem automatically to improve the public good.

The only effective safeguard for ordinary people is the ability to make a free personal choice among competing suppliers whose livelihood depends on satisfying the final consumer.

Dedication to that principle from 1984 onwards is what places the present Government squarely in the established Labour tradition of putting the needs of the common people first.

The abolition of privilege is the essence of structural reform. Wherever possible, use your programme to give power back to the people. That is central to both democracy and market *socialism* and why it is not inconsistent with policies to be followed by Labour or Left Wing parties.

The National Party's 1975-84 policies were privilege in action.

PRINCIPLE NO. 10
Elect politicians who have the guts to undertake structural reform

Conventional politicians ignore structural reform because they think they are in power to please people and pleasing people does not involve making them face up to the hard questions.

They use the latest polls to fine-tune their image and their policies in order to achieve better results in their next poll. In other words, their aim is really to be in perpetual power.

Their adherence to ad hoc short-term policies which focus on their own immediate problems, rather than the country's long-term opportunities leads to accumulating difficulties over time.

It becomes increasingly clear to people that the problems have not been solved and the opportunities have been thrown away. So such Governments end up being thrown out, neck and crop.

Genuine structural reform carried right through fairly and without compromise, delivers larger gains in living standards and opportunity than those achievable by any other political route.

Because Labour implemented such a programme in it first three years, we were re-elected, notwithstanding significant adjustment costs, with a majority larger than our landslide 1984 win.

PUBLIC MANAGEMENT REFORM: THE NEW ZEALAND CASE

Dr Graham Scott

Moscow, April 2000

INTRODUCTION

Across the world countries are redefining the role of government and, as a part of this, reforming their philosophy and systems of public sector management. Considerable reform has taken place over the last 20 years, with most countries embarking on reform programmes in the 1990s. While internationally there is great diversity in the approach and method of these reform movements, there is also at a general level, a surprising degree of convergence about the issues. Prior to this wave of reform, all countries had some kind of traditional bureaucratic model of public management applying across a wide range of functions. The traditional bureaucracy relies on central control, with observance of rules, controls of inputs and highly structured approaches to the employment of labour. It evolved over a very long period of time and has roots in ancient China and Rome. In more recent centuries elements of reform evolved further as in France under the Napoleonic system, Germany under Bismarck, Japan after the Meiji restoration, and the United Kingdom with a major reform to create a professional civil service in the middle of the 19th century. The United States, Canada, Australia and New Zealand all took steps in the early years of the 20th century to enhance the integrity, morale and professionalism of their civil services. The Marxist states created the most extensive and powerful bureaucratic organisations of all.

Why, after such a long history of bureaucratic public management, has there been this worldwide movement to reform it? Has the bureaucratic form of public organisation been a triumph or a failure? Is it being upgraded or abolished? Bureaucracies have been a system of mass production of public services — the engine of the modern nation state and the foundation of the modern welfare state. Over the past century or so, the reforms have been shaped by the scientific revolution and progressivism.

But the bureaucratic form of organisation can also be a system of mass control, rent seeking, corruption and waste. It can be unresponsive to citizens and vulnerable to manipulation by politicians against the wider public interest. It continues to serve citizens well in areas of public management where the disciplined application of detailed rules is necessary for effective management, such as the collection of revenue. The basic responsibility of revenue collecting authorities is to implement the detail of the law as intended by the legislature, rather than to exercise a lot of discretion about how much tax people should pay. There are, however, many areas of public management where rigid application of detailed rules set down in law is not the best way to provide public services. The traditional rule-driven bureaucracy has restricted the ability of governments to adapt their methods of production of services in a way that better meets the needs of citizens and is both more efficient and effective. There is a need for new approaches, particularly where better systems of management can provide gains for the government, consumers and taxpayers.

Management reforms have taken place in many countries to improve the basic bureaucratic model. After the 1960s, the practice of programme budgeting spread from the United States where it was invented, through all the English-speaking countries and more widely around the world. The basic concept involved grouping expenditures together into programmes that represented the policies that the government had in place, which provided much improved information for decisions than the input costs of each bureaucratic institution. This system was intended to involve a detailed approach to setting objectives, allocating resources and monitoring performance with a high degree of central control and direction.

The global reform movement in the past 20 years has spread through many countries, bringing with it a philosophy of greater decentralisation of decision-making, both within the centre of government and from the central government to other levels of government in an endeavour to "let the managers manage". From the mid 1980s onwards, this was augmented by systems of performance management within a decentralised philosophy of public administration. These new models originated mostly from the United Kingdom, New Zealand and Australia. They earned the label "the new public management". Various aspects of this approach have been implemented, with great variety in the adaptations to local conditions around the world, in countries at different levels of development.

Why have so many countries set out to reform their public management systems at the end of the 20th century? This is basically because the quality and effectiveness of public management has a very great impact on the economic performance of a country and on the welfare of its citizens. A country which has skilled, professional policy advisers and great politicians, still cannot manage the economy and society effectively if the instruments of government are not well managed. Poor public management is often a contributing cause to economic instability, generally as a result of poor fiscal, economic and monetary policy. Since the world's capital markets became integrated, the response to poor fiscal management in terms of adverse movements in interests rates and exchange rates is swifter than it once was.

Problems caused by poor public management include ineffective tax administration, poor regulatory environments for investment and malfunctioning delivery systems for services provided by public organisations. Countries have set out around the world to create governments which are more effective and more efficient.

A further general reason for the reform of public management systems globally, has been the movement towards better governance in order to make executive government more accountable to the people it serves. In many countries this has been promoted by the emergence of an educated urban middle class that has growing political influence but is not a beneficiary of the systems of patronage, corruption and privilege run by powerful elites. This influence is particularly evident in the fast growing Asian economies. As a result of this general thrust, many countries have introduced measures for greater transparency, greater accountability, more participation by citizens in the design, implementation and monitoring of public services and decentralisation to lower levels of government.

As a result of these general trends, there is a list of areas where reformers direct their attentions in most countries. These are:

- ✓ Public expenditure management including the fiscal framework and budget system
- ✓ Civil service
- ✓ State enterprises
- ✓ Agencies
- ✓ Restructuring
- ✓ Decentralisation
- ✓ Accountability and transparency; and
- ✓ Managing for results.

The remainder of this paper lists some principles for reform in these areas which have emerged across many countries. Illustrations of the implementation of these principles are drawn from experiences in New Zealand and some other countries. The paper concludes with some principles for the implementation of public management reform and a brief discussion of the relevance of the material presented to developing countries and economies in transition.

CIVIL SERVICE REFORM

Principles of civil service reform

Some general principles and concepts of civil service reform are ubiquitous, although there is great variety in the details and timing of the reform programmes. Countries have designed their reforms to meet their purposes.

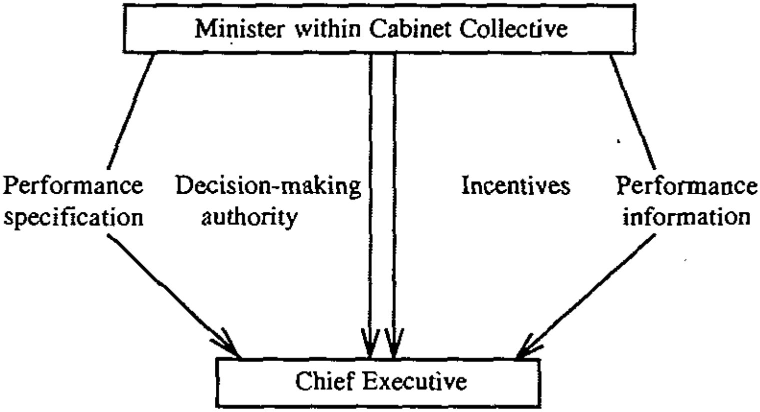
A set of principles which underpinned the reforms in New Zealand included a civil service which is non-political, ethical, stable and accountable. It should be characterised by merit-based appointments, with realistic pay rates. A well-developed culture of service and performance should be present. Many of these principles appear in other reforms, with the non-political principle sometimes being present, sometimes absent.

Why reform?

The newly elected Labour government of 1984 had the powerful force for change in the combination of a fiscal squeeze and capable ministers enthusiastic to improve the performance of the economy and government. Economic growth was low, debt and inflation were rising, there was a large fiscal deficit, and the economy was caught in a web of distorting industry subsidies and regulation. The government was a large player in the economy, supplying many goods and services that were considered better provided by the private sector such as telecommunications, railways, airline services, construction, farming and forestry. Concerns about the quality of policy advice, inefficient government enterprises, the level of government spending and a lack of accountability in the large bureaucracy fuelled a desire for change.

The reform of the civil service focused on a vital foundation — the accountability relationship between the elected politicians and the heads of the government agencies. All ministers are bound by "Cabinet collective responsibility", embodied in rules about how ministers behave. Individual ministers directly oversee specified government agencies. In doing so, ministers represent the interests of the government and exercise these interests within their Cabinet responsibilities. This is expressed through their agreements and relationships with the chief executives of the ministries, departments and agencies they are responsible for. Put simply, ministers are expected to specify their performance requirements and exercise their decision-making authorities. Chief executives are expected to meet performance requirements and provide information to allow ministers or their agents to assess the performance of the ministry, department or agency.

NZ Accountability relationship



State Sector Act 1988

The New Zealand reforms clarified the roles, responsibilities, and accountabilities of chief executives and in doing so, clarified the domain of ministers. The State Sector Act's definition of the roles of chief executives was to:

- ✓ Carry out the functions and duties of the ministry or department, including those created by law or policy
- ✓ Tender advice to their minister and other ministers
- ✓ Attend to the general conduct of the ministry or department
- ✓ Provide efficient, effective and economical management

A significant change brought in by the Act was a new appointment process that involved consultation between the State Services Commission and the minister of state services regarding upcoming vacancies and factors the minister considered needed to be taken into account. Vacancies had to be notified and panels were to be used to assess applicants. The State Services Commission then made a recommendation to the minister who forwarded it to the governor-general for consideration, which in practice meant Cabinet. The recommendation was accepted or rejected and if rejected, Cabinet could direct an appointment or ask the State Services Commission to repeat the exercise.

To date, apart from one case, the Cabinet has accepted the advice of the State Services Commission and has not used its approval role to bring in a political element to the appointment process. This however does remain a possibility.

Another key feature introduced by the State Services Act was the five-year contract for chief executives. Five years was considered a reasonable time for chief executives to set strategic goals, transform an organisation if required and demonstrate achievement. The five-year term helped entrench the non-political element by having chief executives span the three-year election cycle and serve under different governments. Chief executives were expected to retain their positions only as long as they performed well. They could be dismissed for unsatisfactory performance and had no guarantee of a renewed contract at the end of the five-year term.

Under the State Sector Act, chief executives became employers in their own right of all staff in their ministry or department. Chief executives hired, fired and set remuneration levels for staff. Ministers were excluded from any role in this area.

Performance agreements

As well as an employment contract with the State Services Commission, chief executives had annual performance agreements with their ministers who acted on behalf of the government. The agreements differed in focus and content but broadly covered what was to be delivered for the resources voted to the ministry or department, and what the chief executive would do to develop the capability of the ministry or department. This introduced more clarity around the expectations of the ministers and the nature of the outputs they would receive from their ministries and departments.

There were three areas to cover in these agreements. Many concentrated on "key result areas" which were a small number of critical things the department or ministry planned to achieve. These were linked into the wider goals set by the government, known as "strategic result areas". The second element of these agreements related to the outputs to be produced. This involved describing the goods and services produced for the minister on behalf of the government. This included services delivered to third parties such as social services provided to people by government departments. The third element of the agreements involved "ownership" matters — things which the government as owner of the department or ministry would take an interest in, such as the maintenance of physical capital, prudent financial management, and the development of human and intellectual resources.

These performance agreements can be of varying quality and usefulness. In the hands of a capable and interested minister, they can be powerful pools to steer the direction of a ministry or department and can provide incentives for performance. Unfortunately not all ministers are well-positioned to develop sound agreements, nor are all ministers open to seeking advice in this area. There are options for addressing this problem if there is the political will to do so. These include:

- ✓ providing incentives for ministers to take an interest in the agreements and performance of their departments and ministries — e.g., portfolio reviews by the Prime Minister

✓ using advisers, including advisers from central agencies or the private sector

✓ up-skilling ministers in key areas

The budget process and the performance agreements can be linked together. The budget contains the outputs to be produced and the resources voted to the department or ministry. The performance agreements incorporate at the very least, the financial requirements, and in better developed agreements, the outputs and key result areas.

Outcomes, outputs and inputs

Accountability depends heavily on the quality of the performance specifications. The degree of delegation chief executives hold is difficult to justify without clear specifications. There has been much debate about the use of inputs, outputs and outcomes in performance specification.

Outcomes appear in the accountability framework in the form of the government's expectations. They are the results the government wishes to achieve and are often expressed as a change in the status of something in the community, for example an improvement in health status, a reduction in crime or an improvement in literacy levels.

Outputs are the goods and services produced by the government or by an agency contracted to the government. They include health services, education services and advisory services. They can be specified across many dimensions, most commonly quantity, quality, timeliness, location and cost. Outputs are specified at some detail then grouped for the purposes of the government's budget. They are a key part of the accountability framework for the government in its reporting to parliament and for chief executives in their obligations to ministers. Clever departments and ministries are able to increasingly demonstrate links between their outputs and the government's desired outcomes.

There is no clean split with outcomes being the preserve of ministers and outputs being the responsibility of chief executives. Outcomes can also enter the performance agreements if they can be well specified and if the work of the department or ministry can be adequately linked to the outcome. This can be difficult where there are many factors affecting an outcome and it takes careful evaluation and policy work to sensibly augment the accountability for outputs with feasible outcomes.

Inputs are the resources used to produce the outputs and include labour, materials and accommodation. They rarely appear in the accountability arrangements between ministers and chief executives. The output/outcome framework allows ministers to concentrate on what they want to achieve and what is being produced to contribute to that, rather than burying themselves in the details of manning levels and minor capital decisions.

As well as having an interest in what ministries and departments provide, the government has an interest in their capacity to perform now and into the future. The capability of ministries and departments depends on the investment made in physical, human and intellectual capital. This "ownership interest" is strongly present on the radar screen of ministers who appreciate the value of developing and sustaining a high performing organisation. Unfortunately some ministers pay too little heed to this part of their responsibility and provide weak incentives and limited opportunities to chief executives. As one minister of state services remarked, the interest in preserving and developing the ministry or department is sometimes left to the chief executive. There are ways to improve this situation, including providing highly skilled support for ministers from central agencies and leadership from the Prime Minister and other senior ministers.

MANAGEMENT OF PUBLIC EXPENDITURE

Levels of public expenditure management

The focus for the management of public expenditure is the budget process. This ties in the government's goals with the budgets and expectations for its delivery mechanisms — its ministries, departments and agencies.

At the highest level, public sector management involves the fiscal goals of the government and its supporting policy decisions. At a second level, it involves the allocation of funds in accordance with its strategic goals and priorities. At the third level, public sector management involves the efficiency and effectiveness with which resources are used.

Principles of public expenditure management

After experiencing difficulties understanding what was being produced by the public sector, for what purpose and at what cost, the reforming ministers were keen to develop a public expenditure management system which allowed them to have a more informed and appropriate role in determining the high level allocation of resources. Some principles soon developed to become the influencing factors behind the New Zealand public expenditure management reforms. The public expenditure management system should be:

- ✓ Set in a multi-year framework
- ✓ Comprehensive
- ✓ Integrated
- ✓ Legitimate and disciplined
- ✓ Flexible
- ✓ Embedded in all policy decision-making
- ✓ Transparent

- ✓ Stable and predictable
- ✓ Honest and ethical
- ✓ Based on sound and contested analysis
- ✓ Capable of producing accurate timely information and forecasts

The first steps to introducing an improved system came with the Public Finance Act 1989. This Act redefined the appropriation process so that it promoted accountability for performance in terms of outputs as the method of describing what ministries and departments would produce for the resources they were allocated. This became a core aspect of the performance requirements for chief executives. The Act removed many administrative controls and made chief executives responsible for the financial management of their ministry or department. It set out clear and comprehensive reporting requirements.

Government Financial Statements

The government accounts moved from cash accounting to accrual accounting for every ministry, department and agency. This provided the government with a more accurate picture of its financial position including its liabilities. As well, international accounting standards were required, which improved the quality of the financial information at all levels in the government.

Fiscal Responsibility Act 1994

A major step forward in fiscal transparency came with the Fiscal Responsibility Act of 1994. This Act imposed a medium and longer-term fiscal framework on the government. The framework includes:

1. Economic and fiscal updates for a three-year budget planning period. These include economic information on the GDP, consumer prices, current account position and the balance of payments. The fiscal information covers the forecast financial statements, including a statement of financial position, an operating statement, cashflow statement, and statements of borrowings, commitments and specific fiscal risks.
2. Budget policy statement setting out:
   - ✓ The government's long-term fiscal objectives including operating expenses, revenues and balance, levels of total debt and net worth
   - ✓ The government's explicit intentions for the same key fiscal aggregates for the budget year and the following two financial years
   - ✓ The government's broad strategic priorities for the coming budget
   - ✓ Explanation on any inconsistencies to previous budget policy statements
3. Fiscal strategy report for tabling with the budget, setting out:
   - ✓ Comparison of the fiscal forecasts in the economic and fiscal updates

with the government's objectives set out in the Budget Policy Statement

✓ Progress outlooks with projections of fiscal trends covering at least the next 10 years

✓ Comparison of the progress outlooks with the long term fiscal objectives set out in the Budget Policy Statement

✓ Explanation of inconsistencies between the budget Policy Statement and/or the Fiscal Strategy Report and the immediately preceding statement of report

As well as setting a fiscal framework and requiring international accounting standards to be met throughout the government, the Act sets out principles of fiscal responsibility for the government. The principles require the government to:

✓ Reduce total government debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total government debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the government in each financial year are less than its total operating revenues in the same financial year

✓ Once prudent levels of total government debt have been achieved, maintain these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the government do not exceed its total operating revenues

✓ Achieve and maintain levels of government net worth that provide a buffer against factors that may impact adversely on the government's net worth in the future; and

✓ Manage prudently the fiscal risks facing the government

✓ Pursue policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years

The Fiscal Responsibility Act has succeeded so far in its purpose of constraining the government of the day from imposing fiscal burdens on the future by unjustified borrowing to finance current consumption, which New Zealand governments had often done in the past. Several countries are adopting the concepts and some of its provisions are similar to those of the IMF code on fiscal transparency, which emerged in 1998.

STATE ENTERPRISE REFORM

Reasons for reform

The government's trading activities were large in scale, accounting for about 12 per cent of GNP and 20% of investment.[1] The government of 1984 moved rapidly to place businesses in the form of state owned enterprises. Many were privatised over to next decade.

[1] B. Spicer, D. Emanuel, M. Powell, *Transforming Government Enterprises*, Centre for Independent Studies, Wellington, 1996, p. 9.

The motivations for reform came from the high costs, poor services and large fiscal risks for the government. For the twenty years to 1986, the government invested $5,000 million of taxpayer's money in the departmental trading activities of the Lands and Survey Department, Forest Service, Post Office, State Coal Mines and the Electricity Division of the Ministry of Energy. In 1986 these organisations managed asset values of over $20 billion but made no net after tax return to shareholders.[2]

The 1984 Minister of State Owned Enterprises, Richard Prebble, remarked that the managers of the 23 government businesses all brought him similar reports. "Last year's results are disappointing but next year's will be better providing we receive the capital we require from Treasury — something they have so far declined to give us."[3] The Minister noted that their total capital requests came to $10 billion with plans for a further $10 billion. The combined sum was greater than the government's total budget.

State Owned Enterprises Act 1986

The State Owned Enterprise Act 1986 fundamentally changed the objectives and ownership structure of the government's trading enterprises. They were given a principal objective to operate as successful businesses. Subsidies and restrictions were removed. If the government wanted a state owned enterprise to provide non commercial services, it had to enter into an explicit agreement for the services and state the price to be paid.

The law required the shares in the state owned enterprises to be held by ministers. The ministers appointed boards, usually people with business experience, and held them accountable for performance. The boards developed business plans which were reflected in a "Statement of Corporate Intent" tabled in Parliament by their minister each year. The annual reports against the statements of corporate intent could be scrutinised by parliamentary select committees. An additional monitoring source was the Treasury, which monitored the fiscal performance of the state owned enterprises. Annual independent audits provided the final formal piece of the monitoring framework. As well, state owned enterprises had to be responsive to customers, particularly in areas where they were no longer monopoly suppliers.

Results of State Enterprise reform

A comprehensive study of performance before and after corporatisation found:[4]

- Increased levels of operational efficiency (measured by sales/ assets and other output input ratios)

[2] Cited from S. Jennings and R. Cameron, "State Owned Enterprise Reform in New Zealand", in A. Bollard and R. Buckle (Eds), *Economic Liberalisation in New Zealand*, Allen and Unwin, Wellington, 1987; also in R. Douglas and L. Callen, *Towards Prosperity*, David Bateman, Auckland, 1987, p. 234.

[3] Richard Prebble, *I've Been Thinking*, Seaview Publishing, Auckland, 1996, p. 41.

[4] B. Spicer, D. Emanuel, M. Powell, op cit., p. 171.

- Increased levels of profitability
- High performance compared to listed public companies or companies in the same industries

The study noted that deregulation as well as improved corporate governance contributed to the gains. Some figures indicate the scale of change in the state electricity and coal industries:

- Electricity Corporation of NZ's return on assets moved from around 13% 1980-1985 to 20% 1988-1990. GWh of electricity sold per employee moved from around 3-4% in 1980-1987 to 7% by 1990. There were 6000 employees in 1987 and only 3913 by 1990. Profitability increased at the same time as it reduced the average sales price per kWh. In real terms price per kWh fell from 4.90c in 1988 the first year of corporatisation to 4.70c in 1990.
- Coal Corporation increased coal production per employee from the end of State coal era, with a production rate of 820 tonnes per annum in 1987, to 2,482 tonnes per annum by 1991. Earnings before interest and tax were frequently in the negatives in the State Coal era, and as high as –$10M. By 1991, it was around $15M. Sales volumes remained steady and the real price of coal decreased from a high of $90 per tonne in the State coal era to around $50 per tonne in 1991. The gains in profitability were due to cost reductions.

Other examples are Telecom productivity rising 85%, prices dropping 20% and NZ Post productivity rising 120% with a turnaround from a loss of $38M to a profit of $43M. Rail moved from a $77M loss to a $41M profit with a drop in prices of 50%[5].

Across seven of the larger SOEs from 1988-1992 revenue rose by 15.5% to $5.9B, after tax profits rose from $262M to $1023M, staff numbers fell from 67,600 in 1987 to 31,500 in 1992 and the dividend contribution to the state by 1991/92 was $700M.[6]

Privatisation

There are limitations to the extended use of the state owned enterprise model. It lacks the disciplines of the capital markets. There is no monitoring of performance by equity markets, no threat of take-over by other entities and no shareholders with personal claims to profits and exposure to losses. Lenders can also perceive an implicit government guarantee and be less rigorous in monitoring profitability, even if in fact there is no such guarantee. Shareholding ministers can be influenced by short-term imperatives and political expediencies, which do not favour sensible investments in the state owned

[5] According to information provided by the State Owned Enterprise Unit these results were achieved within the period from the introduction of the policy in 1986-87 up to 1992 and in some of the enterprises well before the end of this period.

[6] R. Douglas, *Unfinished Business*, Random House, Auckland, 1993, p. 181.

enterprises. Governments have many calls on their funds and can be reluctant to provide large capital investments. They are also risk adverse and can limit the expansion of state owned enterprises into new markets. Policy reasons such as not crowding out the private market can also restrict the development of state owned enterprises. In fast-changing industries, being unable to diversify and invest as fast as their private competitors can seriously handicap state enterprises. The government cannot however allow them to enter new markets and take over private companies as this is implicit nationalisation of the private sector.

State owned enterprises have made significant gains then found it difficult to progress further under government ownership. New Zealand governments have privatised many of the state owned enterprises.

The 1988 Labour government began an extensive program of asset sales. In every case, the regulatory framework was reviewed to ensure that competition and contestability could prevail. Efficiency and debt reduction were the major drivers for the privatisation programme. Many state owned enterprises were among the entities which were privatised, including Air New Zealand, Petrocorp, Postbank, Shipping Corporation, Government Supply Brokerage Corporation (NZ) Ltd, Maui/Synfuels, New Zealand Rail Ltd, Government Computing Services Ltd, Tourist Hotel Corporation of New Zealand Ltd, and Telecom Corporation.

Politics played a large part in decisions on what to privatise and when during the 1990's. By 2000, 18 state owned enterprises remained in existence. Many are small enterprises, with the larger ones being in the areas of electricity generation, grid transmission services, postal services, and television.

INDEPENDENT AGENCIES

The nature of the agencies

In between the core government services such as Revenue, Treasury and Foreign Affairs and the trading enterprises, lies another form of government entity — independent agencies, known as Crown entities in New Zealand.

These agencies perform a variety of functions including regulation, service delivery and provision of advice. They currently number 231 plus another 2,664 school boards of trustees.

These agencies are usually more independent of routine ministerial control. Some have boards. They tend to have greater freedoms over staffing matters and some have greater financial freedoms than the core public service. Like state owned enterprises, they produce statements of intent which are tabled in parliament and scrutinised along with their annual reports, by parliamentary select committees. They also have purchase agreements to cover what they will produce for the funds they receive from government as well as covering other matters. They are monitored by a ministry on behalf of a minister and assist this process through providing regular financial reports to the Treasury and performance and financial reports to their ministers. They are subject to independent annual audits on their finances and their service performance.

Some lessons

There have been performance problems with some agencies. Multiple and conflicting objectives can make the agencies difficult to manage. The better performing agencies sit inside a policy framework which has been well set up in terms of the roles and incentives of ministers, ministries, boards and CEOs. A warning though — even good policy frameworks cannot guarantee performance if ministers, boards, management or monitors are not up to their jobs. The policy framework has to be designed to fit the capabilities of the people involved with the agency.

There should be clear performance requirements — an obvious thing to expect but a difficult thing to achieve in practice where there are conflicting objectives operating on ministers, boards and management. The internal and external performance requirements must be aligned. There is no point in having high level ministerial objectives which are never translated through to the work activities of staff. A process must exist for aligning objectives and translating these to operational levels. An approach which has made considerable progress in aligning internal and external accountabilities, has been the use of a strategic business planning process which produces a draft plan used to inform ministers in their priority setting. The draft plan is adjusted to meet ministerial requirements then used as the basis for forming the internal and external accountability requirements, right from the purchase agreement and statement of intent through to the performance expectations for staff.

Another lesson has been the desirability of not creating agencies to escape central controls or problems within central agencies and line ministries. It is better to deal directly with the performance issues.

Many functions of government are not suited to an independent agency, such as policy making functions which interact daily with the decision making functions of a minister.

Before creating an independent agency, careful consideration should be given to roles, relationships, incentives and information flows under each structural option. If these cannot be satisfactorily analysed with the problems identified and strategies for dealing with them developed, then politicians should be aware that they might be bringing a troubled child into the family. Once established, independent agencies should be monitored and managed with an eye to the dynamic influences that govern their evolution. Incentive and accountability arrangements can have major influences on whether a particular agency gets better or worse as it evolves.

STRUCTURAL REFORM IN CORE GOVERNMENT ACTIVITIES

Principles

Most core government activities were restructured during the 1980's and 1990's. Several principles underpinned this restructuring.

There was a separation of ownership and purchase responsibilities. "Ownership" responsibilities referred to the interests of the government as owner in the continuing capability and development of the ministry or department, including development of its physical, human and intellectual capital. Ownership interests also extended to financial management and risk management. The purchase interests referred to the interest in the goods and services provided by the ministry or department, such as policy advice, monitoring services, and so on.

A second principle was the separation of policy making from operational activities to avoid domination of policy advice by the operational needs. For example, the Ministry of Justice provides policy advice while the Department of Courts provides courts and associated services and the Department of Corrections provides prison and associated services.

A third principle was the separation of funding, purchasing and provision of services. A notable area where this was pursued was in health where the Ministry of Health was the funder, the Health Funding Authority was the purchaser and Hospital and Health Services were the public hospital service providers.

A fourth principle was competition between service providers. This principle had many complexities to it. One was the issue of whether the government should be competing with private enterprise. Another was the difficulty of creating competition where natural or political monopolies existed. Yet another consideration was the mixed incentives on ministers to seek alternative providers of advice as this could reduce the capacity of the departments and ministries they controlled.

A fifth principle was the reallocation of functions for focus, synergy and transparency. Large conglomerate ministries were dissected into more manageable forms, such as the Department of Social Welfare's division into three departments and a ministry — the Department of Social Welfare, Department of Work and Income, Department for Children and Young Persons and the Ministry of Social Policy.

Accountability and transparency

Accountability and transparency for the core public service comes from five areas.

The Parliament monitors service and financial performance through scrutiny by select committees of the statements of intent, annual reports and other matters.

On a more regular basis, ministers monitor progress with assistance from central agencies which monitor financial performance (Treasury), CEO performance (State Services Commission) and performance on issues of concern to the Prime Minister (Department of Prime Minister and Cabinet).

There is an independent annual audit of financial and service performance as well as ad hoc audits of matters such as risk management, IT management and the strength of management systems.

A fourth monitoring source is the independent commissions such as the Privacy Commission, the Environment Commissioner, Ombudsmen, Race Relations Commission and the Human Rights Commission.

Finally, the public are able to assess performance through the reports made available and through their ability to seek a wide range of information under the Official Information Act. They may also seek a judicial review of decision making by government agencies.

Results

Any broad scale assessment of the reform of government ministries, departments and agencies must acknowledge the problem of the benchmark or counterfactual against which the changes are to be compared. Comparisons can be made for parts of the reforms in some areas, such as the state owned enterprises, but generally, comparisons pre and post reform are not easily made.

A quick check against some criteria can be made:

✓ The reforms have been accepted by governments since their implementation in the 1980's. Even the new government of 1999 which campaigned on further public sector reforms, has indicated through its Finance Minister that the State Sector Act, Public Finance Act, and Fiscal Responsibility Act will not be changed.[7]

✓ Scrutiny by parliament has improved.

✓ Budget processes are more effective, with better linkages between government priorities and expenditure.

✓ Efficiency gains have been made.

✓ There is better information available — including better data for developing macro-policy.

Another way to gauge the reforms is to go back to the objectives set by the reforming politicians. The 1987 Labour government was seeking greater efficiency, better information, increased fiscal control, tighter accountability for delivering on the government's objectives, the ability to shift resources from low to high priority areas, and an end to the employment protections peculiar to the public service. Significant gains have been made in every objective.

[7] Statements made in a television interview June 2000.

Senior politicians throughout the 1990's have expressed satisfaction with the public management system, including the Prime Minister, Minister of State Services and Minister of Finance.

Ten years on, there are old lessons to remember and new challenges to face. Some areas of weakness have been left unattended for too long, such as dysfunction with some independent agencies due in part to poor policy design and problems in implementation.

The Labour/Alliance government of 1999 campaigned on a platform of strengthening the public service and criticising the functioning of government agencies and personnel. There is no evidence that the new government has a clear and consistent way of thinking about the structure and performance of the government sector. They are creating many district health boards with the objective of taking decision making closer to communities, while removing decision making by school boards through the removal of decision rights over funding and other key matters. The new government looks poised to dilute the principle objective of SOEs such as TVNZ and to reduce their management and other operational autonomy. By combining the funding, purchasing, and monitoring roles in the Ministry of Health and by combining the purchasing and provision roles in district health boards, the new government is moving away from another key principle underpinning the public sector reforms. Structural reform in the absence of attention to roles, relationships, incentives and information flows and without attention to a coherent framework of design, will produce unexpected and unintended consequences.

Implementation

The lessons from the past suggest that in reforming government, the reformers need to consider the requirements for designing and implementing successful reforms:

- ✓ Clear definition of the problems to be solved and widespread acceptance of the diagnosis
- ✓ Robust analysis leading to solutions which take into account major factors influencing the success of reforms including the roles, relationships, incentives and information flows for the reformed entities — a systemic analysis is required
- ✓ Clear picture of the desired results
- ✓ Political commitment to solving the problems and implementing the chosen changes
- ✓ Leadership from the top of the bureaucracy to empower change agents below
- ✓ Widespread communication of the problems, options, decisions, and implementation strategy
- ✓ Early results — early successes
- ✓ Careful management of transitional risks
- ✓ Commitment to persist for years

SHOULD DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION ADOPT NEW ZEALAND STYLED REFORMS?

There has been some debate around the World Bank and the IMF about whether developing countries and countries in transition from communism should attempt to implement a public sector reform programme based on the new public management system. The debate is rather abstract because no country ever adopts another country's public management system without considering its own situation, capabilities and priorities. But there is an interesting question as to whether developing and transition countries might be able to miss out some of the stages of development that the most advanced systems of public management have evolved through over many years. The question is whether this is a wise course of action.

The main contributor to this debate has been Professor Allen Schick from the University of Maryland who argues that most developing and transition countries should not try New Zealand-style reforms. His argument is as follows.

In the New Zealand system, formal agreements about performance take the place of implicit understanding about what is expected in more traditional systems of management. Developing and transition countries do not have a basis for arriving at, and implementing, formal agreements or contracts for service delivery in either their public or private sectors. Public managers in these countries cannot be trusted with freedom over decisions about how to use resources and so the new public management approach, which relies on managerial freedom and accountability for results, cannot work.

Also in those countries, central controls in the management system are evaded by informal practices which can, in some circumstances, be efficient but can also breed corruption and inefficiency. This informality is accepted as the prevailing culture. Schick argues that government reform in the direction of accountability for performance cannot precede the reform of private markets in honouring contracts in commercial activities. He thinks that the government must first develop sound contracting institutions in the private sector before extending it into the government.

Therefore he argues that the formal system of central controls in the government should be made to work, before trying to introduce management freedom and performance accountability. This means improving pay, controlling inputs and ensuring compliance with rules that are fair and workable, before shifting the focus of attention onto outputs. Once this is done, input controls can be loosened over time and the control changed from pre-approval to ex-post audit.

He summarises his position by saying that these countries should follow the evolution that Singapore did on its way to one of the most advanced systems of public management but these countries should not miss out steps in that evolutionary path.

This argument has a lot of merit but is, in my view, based on some assumptions that are a little exaggerated. There is a degree of informality, in the sense of getting around rules, in every society including those where new public management systems have been installed. The New Zealand system is not an exemption and some informality and agreements based on working relationships between people rather than written contracts, are quite common. It is true that there is little or no corruption in New Zealand which facilitates the granting of management freedom, but it is equally true that the systems of formal control in developing and transition countries often co-exist with high levels of corruption. So the question arises as to whether increasing management freedoms in those countries at the same time as introducing better management information and accounting systems, would produce a worse situation than trying to tighten the formal controls that have for many years been evaded. The answer will depend entirely on the circumstances of a particular country.

Professor Schick's proposal that the government should promote an ethical and formal system of private sector contracting before introducing it into the public sector appears to assume that a government which is corrupt and inefficient will be able to promote such policies in the private sector. Surely it should attempt to address its own problems of inability to manage contractual relationships at the same time.

In particular circumstances, there is likely to be some elements of the new public management approach which could hasten improvement in service delivery in some developing and transition countries. In my experience, there are countries where it would be a mistake to assume that the central authorities of the government will lead a movement for reform when those authorities are often the most backward, corrupt and have strong incentives to keep the present system in tack. In some of these countries public services are in a desperate state and there may be options for devolution via performance contracts of some kind to local community organisations and non-government organisations which can bring more rapid improvement in services than hoping for reform from the centre. For example, in many poor countries the Ministry of Finance diverts the money that the Parliament intended for vital social services into other priorities often of its own choosing. Removing the discretionary authority of Ministry of Finance in these circumstances may bring improvements in social conditions. I have no reason to believe that corruption at the local level would be any worse than it would have been otherwise with whatever money arrived there.

It is a mistake to think that people are inherently corrupt by nature, as corruption is heavily influenced by pay levels, incentives, lack of proper systems of accountability and organisational culture. Organisational culture can change quite rapidly anywhere under favourable circumstances. Corruption can be addressed by removing incentives and opportunities to exercise the discretions which provide the opportunities.

So in conclusion, while I am in broad agreement with Professor Schick's argument, I think some components of new public management systems may be more likely to bring improvements in particular circumstances than always relying on an enlightened approach to reform from the centre of the government. Some aspects of reform, such as the linking of expectations of performance to the budget, can promise gains. Other aspects of reform are not so readily applicable, such as very deep delegations of managerial freedom with accountability for performance. This can be impractical in low income developing countries and countries in transition. It should also be noted that not all countries with new public management systems are highly developed.

Occasionally there are countries whose top politicians are determined to make a radical break with the past and to look for a more immediate transformation of culture and performance. The first non-communist government in Mongolia was an example of such a situation. They were determined to take a calculated risk and to make rapid improvements in service delivery. A constitutional crisis unrelated to their attempts at reform, halted the programme. In their judgement, the risk of radical transformation was worth the potential gain. They were not as constrained in capability as many poor countries, because of the legacy of the Soviet era which had left a large number of highly trained people in the public sector who had the capability to implement change if continuing leadership and drive had remained in place.

The shape of any public sector reform has to be matched to the requirements and capabilities of the country undertaking the reform. The reform must rest on an astute understanding of the main issues, what the proposed reforms are expected to achieve and how they will be implemented. As with all major changes, I would caution against entering the swim, until there is a thorough understanding of who will gain from the reforms and who will lose and a plan is developed for capturing the hearts and minds of the winners while managing the influence of the disaffected.

BALANCE IN THE 90's
Pacification, Stability and Growth

*Carlos B. Bolona**

At the end of the 90's we were in the middle of a strong economic recession in which both banks and companies were in debt. This caused many people to lose hope and made them question the economic model and the advances made in this decade. Even so, this same government had not advanced with many reforms. What is certain is that this "brief placidity" was not going to generate a growth platform in the long term. Therefore, it is time to balance the economic results of the 90's and create an agenda for the next decade.

Before starting with the subject of economy, it is important to review some things that characterized our country during the decade of the 80's. In the political and social arenas, the terrorism of Sendero Luminoso [Shining Path] and the Movimiento Revolucionario Túpac Amaru [Túpac Amaru Revolutionary Movement] (MRTA) tried forcefully to impose an anachronistic ideology that the country rejected, resulting in death, violence and destruction. To this we must also add the alliance between the terrorism and the international drug trafficking cartels, that, through the incentive of easy money, received extensive areas of our Amazonía which fell under their control, forcing the government away from them.

Between 1985 and 1990, Alan García and those surrounding him disarmed us by selling twelve Mirage airplanes, which evidently affected the operational ability of the Armed Forces; and, buying planes that were not equipped with artillery, while at the same time praising the mysticism of the Sendero members. Also, we witnessed the massacre of the Frontón and the strange escape of Víctor Polay Campos, the ringleader of the MRTA, from a maximum security prison, along with more than 100 other revolutionary militants, before the end of his regime. García's manipulation of Congress, the judicial court, the Court of Constitutional Guarantees, BCR

* President of IELM.

(Central Bank), the finance office and other institutions shifted us away from a true democracy.

At the end of the 80's, the Shining Path moved its destructive practices to the country's capital and main cities, as demonstrated by car bombs, murders, kidnappings, occupation of schools, etc., which was carried to the extreme of considering certain populated centers, such as Huaycán, as "liberated zones".

In this climate of general hopelessness, the country faced an electoral process in which Alberto Fujimori appeared as the candidate of a new, mostly unknown, movement. He brought with him a message of "honesty, technology and work", and in his second electoral turn he was elected national President. The most important and unusual thing was that he announced immediate measures and put them into action, as the country undeniably required. He eliminated the terrorist groups, restored the principle of authority and led to the reconstruction of the State; also, he gave clear directions to fight corruption and drug trafficking, dictated a legal framework for the police, farmers' groups and self-defense groups in the fight against narco-terrorism, and, in addition, initiated treaties to resolve differences with Chile and Ecuador.

Today, we live in a climate of domestic peace, thanks to the defeat of the terrorists and the consolidation of National Pacification. Foreign peace has been obtained by signing a peace agreement with Ecuador and concluding the 1929 Treaty with Chile.

When we begin analyzing economic results, in the 90's the following may be observed: GDP grew to an annual average of 5.0%. We started with a recession, as a result of the bankruptcy of García, and ended the decade with a strong recession due to the global crisis and the El Niño Phenomenon. Inflation was reduced from 7.650% to 4% annually, close to the international inflation rate. Official unemployment fluctuated between 8% and 10%, reaching its highest levels at the end of the decade, due to the recession. There was greater opening to the outside world: Exports of goods and services increased from US $4 to US $8.8 billion (an average annual growth rate of 7.8%). Imports of goods and services grew from US$5.4 to US$12.3 billion, to slow to US $11 billion during the last year, due to the recession. The cumulative current account deficit during the decade reached levels of US $24 billion, financed by a cumulative surplus of US $34 billion in the capital balance, leaving a positive balance of US $10 billion in net international reserves.

The current account balance, as a percentage of GDP, has moved from –3,8% (1990) to –7,3% (1995) and –6,0% (1997) due to the "political cycle", adjusting itself soon thereafter to a level of –4%.

The surplus in the capital balance increased from US $1.5 billion (1990) to US $5.6 billion (1994) to be reduced by half in 1999. International reserves moved from US $500 million in 1990 to US $10 billion in 1997, only to drop by US $1.7 billion during the current recession.

The Size of the Government was reduced from 25% of GDP in the 80's, to 12% during 1991-92, soon to increase to around 17% by the end of the decade. The budgetary deficit was reduced from 7% to 2% of GDP. The foreign debt was reduced from 115% of GDP in 1988 to 50% of GDP in 1998. The tax system was simplified from 200 to less than 7 forms of taxes. The internal debt was eliminated, except in the case of retirement pensions. In terms of public expenditures, the state has invested US $8 billion in energy infrastructure, transportation and communication, sanitation, health and education. National coverage by the electricity grid has increased from 50% in 1990 to 70% in 1998. Twelve thousand km. of asphalt roads have also been built and renovated, as well as 24,000 kilometers of rural roads and 49,000 kilometers of graded roads. In education, 57,000 classrooms have been built.

The programs to alleviate extreme poverty have reduced extreme poverty from 26% to 12% in this decade by means of social programs on the order of US $3 billion dollars.

On the subject of economic reforms, the following results have been obtained:

MACROECONOMIC REFORMS:

Fiscal discipline has reduced the budgetary deficit to 2% of the GDP, but it is very precarious and is subject to a "political cycle" and the tendency to expand the state at the expense of the private sector. Monetary discipline has been variable, occurring at odd times, with issues at 3.3 times the inflation rate, for the purposes of buying dollars. Monetary and budgetary discipline was obtained through the liquidation of the Banca de Fomento (National Development Banks), which had been a permanent drain, with its constant bankruptcies.

The manipulation of key prices in the economy was disappointing. The real exchange rate deteriorated during the decade, interest rates remained high, both in soles [Peruvian currency] and in dollars, and controlled prices were subject to delays due to political pressures. These inadequate tendencies could have been corrected, by lowering internal inflation to the level of international inflation in a much shorter period (i.e. 2 years).

MICROECONOMIC REFORMS:

Prices, competition, deregulation and market efficiency (goods and services, capitals and labor) have all been freed. In order to achieve greater efficiency, import duties have been reduced from an average of 75% (with a 73% dispersion) in July 1990 to 14% (with a 6% dispersion) in 1997. Import surcharges have generated a distortion in favor of manufacturers of processed food products and against the population in general.

The capital markets increased their stock capitalization from US $1 billion to US $15 billion, and today it is in the US $10 billion range. The annual negotiated amounts reached US $12 billion in 1997, soon to drop to half that amount in the present recession. The banking system increased its assets from US $5 to US $22 billion, raising its credits from US $2 to 13 billion, financed by an increase in deposits from US $3 to US $13 billion and foreign bank debt balances from US $215 million to US $4.4 billion. Banks and companies recovered and then fell back into debt, with companies owing as much as they sell and debt equivalent to 65% of their assets. Faced with the loss of capital, due to the crisis, bad loans exceeded 15%, and many companies had serious solvency problems. An exit must be made by means of the capitalization of debts between banks and companies, through new partners with less state intervention. The restructuring occurs at the level of each sector (i.e. foods, poultry, fish flour, etc.). The labor market has been made flexible (i.e. through Service Time Compensation Fund (CTS), collective negotiations, wages, etc.), but a series of surcharges still remains, which increases the price of job creation.

PROPERTY REFORM:

The privatization of assets has generated an income of US $8.7 billion and projected investment of privatizations amounted to US $7.0 billion. Also, there is greater competition, better services and prices in the area of telecommunications, electricity, water, etc. Of total privatization resources, US $3.6 billion, (28%) went to the Consolidated Welfare Reserve Fund (FCR), 12% to Development Compensation Fund (FONCODES), 14 % to infrastructure, 8% to Ministry of Economy and Finance (MEF) and 11% for other purposes. The use of funds could be more transparent and provide more appropriate information.

Foreign investment that reached US $15 million during 1985-90, has reached a cumulative amount this decade to the tune of US $15 billion, concentrated on telecommunications, mining, energy and industry. This would not have been possible without resolution of legal conflicts with Southern, OXY and AIG-BELCO (multi-national companies) and the company/signature in agreement with other companies, such as: MIGA, OPIC, among others.

IN THE MATTER OF INTELLECTUAL PROPERTY WE HAVE PROGRESSED, BUT IN THE PROCESS OF PRIVATIZING REFINERIES, ELECTRICITY, WATER, PORTS, AIRPORTS AND HIGHWAY CONCESSIONS WE HAVE NOT ADVANCED.

The privatization of social benefits (this is the population's forced savings) has generated: a private pension fund in the amount of US $2 billion, (with 2 million members), a Service Time Compensation Fund (CTS), a new private health fund, but the opportunity for a private housing fund was missed.

Agriculture is the forgotten sector; profitability in this sector has not been restored, subsidies remain and a new, yet slow privatization process has not allowed for rapid capitalization.

Finally, the "Privatization of the Private Sector" (to privatize gains and losses), has still not been understood and/or digested by some members of this sector, who never lost hope that the government would socialize their losses and their risk of bankruptcy through "investment banks" or their subsidiaries.

STATE REFORM:

The State has not been reduced, but on the contrary, continues to grow at the expense of the private sector. The level and the quality of public expenditures have not been adjusted. Clarifying the expenditures and "fiscal responsibility" have not been consolidated. No automation and enhanced efficiency of the bureaucracy have taken place.

INSTITUTIONAL REFORMS:

Our institutions have been weakened and we have not advanced in reforming the judicial branch, the Court of Constitutional Rights and the national electoral college to obtain greater reliability, responsibility and "accountability" with the intention of strengthening the rule of law and democracy in Peru.

CONCLUSION:

The severe recession of 98-99 does not allow us to see clearly the progress made during the 90's. We can get out of this recession in a shorter time and at lower cost in 2000, but "short-termism" does not have to distance us from growth over the long term.

The economic model applied here has provided positive results in the 90's in the area of growth, price stability, fiscal and monetary discipline, international reserves, savings and investment, and advances in the fight against poverty. Nevertheless, the government has become paralyzed in the area of reforms; it has lost "momentum". It is necessary to retake the reforms and introduce a second generation of reforms if we want to grow 6 to 7% annually, have inflation equivalent to international inflation, obtain savings and investment equivalent to 25% of GDP and eradicate extreme poverty in the next decade. It is necessary to carry out state, institutional and labor reforms, as a second wave of reforms. Also, property reforms, and micro- and macroeconomic reforms must be strengthened.

Chile went bankrupt in 1982 by applying the model incorrectly and fixing the exchange rate at any cost. Nevertheless, it persevered, recovered, and in the 90's it started buying companies and exporting capital to several Latin American countries. In the current crisis it will be one of the countries that will come out of the crisis in less time.

In conclusion, the 90's have been positive in the matter of pacification, stability and growth, compared with the disaster of the 80's. The economic model and reforms must be strengthened to lead Peru down the path of stability, prosperity, peace, rule of law and democracy. These are the fundamental goals of the coming decade.

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(Revista Sí, December 27, 1999)

ECONOMIC PROPOSAL FOR PERU 2000-2005

Carlos Bolona

1. THE EMERGENCY PLAN TO EXIT THE CRISIS

From 1998-2000 the Peruvian economy experienced a serious recession and a loss of international reserves, due to three severe external shocks (the "El Nino Phenomenon", the Asian crisis and international financial turbulence).

Companies deeply indebted in dollars quickly sustained losses that led many of them into financial difficulties.

Banks lost their external credit lines and showed losses and sluggish portfolios, and began restricting credit to the private sector. Five banks were merged, eliminated or absorbed by the state, and most required significant capital contributions.

When facing such a general crisis, responsibility is shared among banks, companies and government. Each will have to "pay its corresponding share".

Banks will adjust by applying market solutions, mergers, private capitalization, enhancement of risk management and internal controls. Companies are adjusting with market mechanisms such as mergers, capitalization and restructuring.

The government has established a new program of financial reorganization that enhances formal mechanisms for restructuring, facilitates capitalization by banks and establishes simplified procedures to facilitate and accelerate agreements between creditors and debtors. Also, a fund to repurchase the portfolio is being applied.

It is of vital importance to accelerate the restructuring plan, so we may emerge from the crisis this year and begin to show growth of 6-7% as of next year.

2. MACROECONOMIC PROGRAM

The economic goals we must target are: An annual growth in real GDP of 6-7%; a 3% inflation rate, equal to or lower than the international rate; a current account deficit not to exceed 4% of GDP; a budgetary deficit at 0% of GDP; the size of the Government must be near to 15% of GDP; the unemployment rate must be reduced to 3% and underemployment to 15%; extreme poverty must be reduced by 1.5% annually; the inefficiency of the economy must not exceed 10% in real terms; and the levels of saving and investment must reach 25% of GDP.

The instruments of economic policy to be used to reach these economic goals are:

a) Monetary Policy

The issue [of money] would have an explicit monetary goal (3% annually). This requires a reinforcement of the autonomy of the Central Bank and a limit of its discretionary action. This is an alternative to convertibility schemes or dollarization.

b) Fiscal Policy

A neutral, efficient structure is required that primarily taxes consumption. It must maintain a tax burden of 15% of GDP based on: value added tax, income tax, import duties and selective taxes on consumption.

Current expenses must be at 12% and capital expenses at 3% of GDP. Remuneration, goods and services must be at 5.5%, transfers to local governments at 2%, extreme poverty must be relieved by 1.5%, while pensions for the retired must be at 1.5% and interest on internal and external debt at 2% of GDP, respectively. The budgetary deficit must move toward zero, in accordance with a "law of fiscal responsibility".

c) Exchange Policy

The dollar would have to be stable (near zero devaluation) to the extent that domestic inflation is less than international inflation. The exchange system would remain open, especially for the flow of goods, services and capital.

d) Commercial Policy

A uniform customs tariff of 10% should be targeted, for the purpose of obtaining international levels of efficiency and gradually reducing tariff surcharges.

e) Pricing Policy

The key prices of the economy (exchange rate, interest, salaries) will continue to be free and competitive. Prices for public services must be free, competitive and tend toward international levels.

3. POLICIES FOR JOB CREATION

Real and productive — not artificial — employment is needed. This must be created in a context of economic stability and through annual growth of 6-7%.

Investments must be made to create jobs. The healthiest move is for us to save and invest 25% of GDP this year (US $15 billion). This would allow us to create 150,000 jobs directly and 300,000 jobs indirectly each year. Peru's problem is not so much unemployment (Peru: 7-8% unemployment, Argentina: almost 20%), but the low productivity of its markets. Peru is a country of very small businesses with a very large private sector. To increase productivity we need to consider the following:

a) Simplified and unitary processes for creating licenses and pledges that promote the integration and formalization of informal, very small businesses,

b) Access to formal and private credit, through financial policies that provide incentives for the participation of private banks with long-term loans and low interest rates.

It is worthwhile recalling that the most labor-intensive sectors are agriculture, tourism, services, small- and very small businesses.

Employment can also be promoted by lowering the cost to generate it. It has been suggested that for 3 years new employees not be subject to AFP [Precautionary Fund Administration], social security, minimum wages, etc.; that is to say, a 3-year terminating labor contract.

Also, transaction costs between the informal and formal sectors must be eliminated, as well as obstacles, distortions and discriminatory taxes.

4. SECTOR-RELATED AND SPECIFIC POLICIES

a) Agriculture There are various aspects to which the reforms must be directed:

Infrastructure: Market access is still difficult, which is why it is still necessary to develop infrastructure in the rural sector.

Irrigation: Water subsidies must be eliminated and the administrative structure for water reformed, for which reasonable legislation must be passed on water rights.

Health standards for agricultural products: A monitoring and regulatory system is needed which will allow the development of export-quality products, thus providing an incentive to agricultural exports.

Increase of productivity through:

✓ Secure and indispensable property rights: (i) Reform the register of personal property; (ii) Simplify and rationalize the license issuing process; (iii) Introduce alternative mechanisms for resolving conflicts (for instance, mediation, arbitration).

✓ Access to credit: (i) State intervention must be transparent, and if subsidies are granted, they must be direct to avoid distortions; (ii) Banks must differentiate between their clients and the sectors they finance.

Forest Law: This law must be implemented, while at the same time developing a regulatory mechanism for forest use.

b) Reduction of Extreme Poverty

There are 4 million Peruvians in extreme poverty who spend less than $1.14 daily. We must identify this population in order to assign resources to them adequately. We must work with programs at the district level. The strategy must consider:

Nutritional programs: Directed at the infant population (2 million infants and 5.8 million school-aged children) in poverty or extreme poverty situations, and later to pregnant women, nursing babies and the elderly. An annual amount of US $300 million would be designated for this purpose.

Basic preventive health package: This would require an annual investment of US $330 million to guarantee access to the entire population.

Education expense: It is necessary to designate US $650 million annually for this purpose.

Costs of basic infrastructure: Investments in water supply networks, sewage systems and public lighting.

c) Education

It is not enough to build a school a day, raise teacher salaries, or double investment in education. We must change the educational model in the following ways: Move from a 1% graduate level to 99% of the people educated; from mass education to personalized education; from teaching to learning; from the dictatorial teacher to the facilitator; from financing supply to investing in demand; from duopoly to competence; from the bureaucratic to the business model; with education seen as an investment in human capital; and education for change; where wealth is to be found in the minds of our people.

d) Decentralization and Municipal Reforms

The goal is to decentralize the country through reforms intended to strengthen the provinces and municipalities. There are 190 provincial municipalities and more than 1,900 district municipalities. The municipalities must become essential actors in the fight against poverty, applying government plans in the areas of nutrition, health and education, as well as health and housing programs for low-income people and special employment programs.

To this end municipalities must be able to count on money transfers and financial aid from the central government, financial sources of municipal taxes, and a legal framework that allows a more flexible and appropriate handling of the budget and personnel.

e) Foreign Investment Policy

Direct Foreign Investment must be promoted so it may increase from the US $1.5 billion annually in the 90's to US $2.5 billion annually in the first decade of 2000. We must continue to concentrate on: mining, energy, hydrocarbons (Camisea), telecommunications, finances and fishing. We must also provide incentives for: agriculture, agribusiness, tourism, infrastructure (for instance, providing roads, ports, airports, etc.) and privatization.

In order to promote foreign investment it is necessary to have economic stability, as well as confidence, the avoidance of sudden changes in the rules of the game, a reliable legal authority, and a proactive stance in "marketing" Peru to the world and promoting competition.

f) External Debt Policy

External debt with respect to GDP has been reduced from 115% in 1988 to 50% in 1998. In 1996, servicing this external debt represented 40% of GDP with regard to exports. For the next five years we must reduce the external debt to 35% of GDP (US $22 billion), which matches the average level in Latin America, through the exchange of debt for privatization, concessions, the ecology, alleviation of extreme poverty, etc., based on principles of transparency, professionalism and proper information.

5. STRUCTURAL REFORMS

a) Microeconomic Reform

In order to obtain better prices, quality and coverage, it is necessary to promote competition in the various markets and avoid monopoly and oligopoly practices that have recently occurred due to private interests, generating legal monopolies. The sectors to be reviewed are: telecommunications, food, drinks and cigarettes.

b) Property Reform

Privatization

Income from privatization and concessions is expected to reach US $800 million annually.

The most important privatization and concessions we must work on are: airports, ports, roads, refineries, SEDAPAL (water), etc.

The Government is committed to completing the transfer of agricultural land to the private sector, and finishing the competitive bidding on the transportation of gas from Camisea.

Extension Property Rights to the People

To reduce poverty, all members of the population must also have access to private property. We must make Peru a country of proprietors.

COFOPRI (Commission to Formalize Private Property): To date, 770,000 properties have been formalized in 23 cities. It is crucial to reach 1 million formalized properties, which would generate a return of US $1.7 billion.

PROFAM: The Family Lot Program tries to provide the poorest sector of the population with urban property in an orderly fashion. We count on 830,000 registrations the Government must respect, without distortions from incentives or land speculations, to create a long-term land and housing market.

Housing construction: The financing mechanisms of the Government (MIVIVIENDA, FONAVI, ENACE, BANCO DE MATERIALES, MIBANCO) have proven to be inefficient. It is necessary to develop market mechanisms to guarantee 20-year financing at low interest rates.

c) State Reform

The government must be a facilitator and not a provider. It must help create public services with more efficiency and quality for the people of Peru.

We must create mechanisms for work incentives and account rendering on the part of ministries and bodies of the executive branch. We must save on current expenditures by increasing efficiency, eliminating bureaucratic costs and undergoing the necessary decentralization of public bodies. We must make public service professional and deregulate administrative systems.

d) Institutional Reform

This includes reform of the judicial branch, the restoration of the balance of power and the restructuring of political parties.

The application of this economic proposal will allow us to achieve a stable, secure and prosperous economy and to come out of our extreme poverty, generating real and productive employment.

President of the Institute for a Free-market Economy

(El Comercio, Expreso, April 7, 2000)

THE WORLD BANK'S APPROACH AND THE RIGHT APPROACH TO PENSION REFORM

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INTRODUCTION

In the last year and a half, the world has witnessed a remarkable reduction in the valuation of asset prices in developing countries. Measured in dollars, stock values declined by roughly 30 percent in relatively well-managed and politically stable emerging economies like Poland, and by roughly 75 percent in poorly managed and politically troubled economies like Indonesia. This international meltdown of financial markets provides both an occasion and argument for critiquing the World Bank's approach to pension reform. The reason is that exclusive or predominant investment in domestic asset markets is a central tenant of that approach and the source of a variety of equally misguided advice.

Although the World Bank will be the target of this prosecution, it is far from the only defendant. The Bank's approach has been endorsed, either explicitly or implicitly, by other major lending institutions, such as the International Monetary Fund, the Inter-American Development Bank, and the Asian Development Bank. Since the policies of these international lending institutions are strongly influenced by the U.S. government and other major donor governments, the blame for the World Bank's policies must be shared by these governments as well.

At the outset, it should be acknowledged that the World Bank does not speak with a single voice on pensions. It has neither a single pension policy maker nor a pension policy-making committee. Instead, its policy reflects the varied judgments of its country and research economists who mission together in differing configurations to work on particular countries. Moreover, the policies recommended for particular countries are not, at least on the surface, identical. For example, the World Bank has advocated Chilean-type pension privatization in certain countries and notional accounts in others.

Whatever their apparent and actual variety, the Bank's pension reforms reflect and emanate from a common and deeply flawed set of views about the goals and methods of reforming state pension programs. In promoting these views and pursuing these goals, the Bank not only has imperiled the pensions of the current and future elderly of those client countries that adopt its plans, but it has also severely limited those countries' prospects for fundamental economic reform.

To its credit, the Bank has been open to debating its pension policy in a variety of public forums, including an annual international workshop on pension reform that the Bank's Economic Development Institute and Harvard Institute for Economic Development jointly sponsor. The criticisms that have been raised by the author and others of Bank pension policy have generally been dismissed as theoretically correct, but politically naïve. Political naiveté refers here to the proposition that the politicians in the countries the Bank is assisting are precluded, because of political considerations, from pursuing first- or even second-best policies. Consequently, Bank economists feel justified in advocating what they, themselves, often acknowledge are third-best policies.

The lack of central coordination of pension policy at the Bank coupled with the lack of forceful and appropriate leadership by senior Bank management is, in large part, responsible for this sorry situation. The Bank economists who construct pension policies for particular countries are of too low a rank to risk advocating and enforcing a radically different approach than has been advocated and enforced by other collections of Bank economists for other countries. Moreover, the Bank's team approach to providing pension advice via multi-member missions, where the members must achieve consensus, is a prescription for perpetuating and calcifying particular approaches to reform no matter what their merits. The team approach not only stifles policy innovation, it penalizes policy dissent by casting the dissenter as a "non-team player."

In this regard, it is important to stress that "mission failure" is defined within the Bank as failure to make the loan rather than as failure to require appropriate policies as the quid-pro-quo for the loan. Consequently, attempts by mission team members to defend economic first principles can only be done at the risk of "jeopardizing" the mission.

These micro-level problems of mission control have macro-level counterparts. The Bank increasingly finds itself competing with other major lending institutions in providing particular countries with policy advice and financial assistance. In this setting, recipient countries find it easy to play the Bank off against other institutions, pointing out that they need to "ante up" if they want to be a "player." The concern that the Bank or similar institutions would have no presence in a particular developing country, particularly a large developing country, appears to override the concern with whether that presence is actually beneficial.

This critique begins by outlining the legitimate goals of pension reform and contrasting these goals with those of the World Bank's pension reform policy. Next, it describes the Bank's standard approach to pension reform. Finally, it offers an alternative pension reform policy entitled the Personal Security System, developed by the author and Jeffrey Sachs of Harvard University.

THE LEGITIMATE GOALS OF PENSION REFORM

There are a number of legitimate goals of pension reform to which the Bank and this author would both subscribe. The area of disagreement involves how these goals should be achieved and the legitimacy of goals that go beyond those listed below.

Guaranteeing Adequate Income for Workers When They Retire

This is the most important goal of pension reform. It is also the goal most endangered by the Bank's approach. The pension systems of numerous developing countries have been unmitigated disasters on this score, leaving millions of their current elderly in poverty and millions of their current workers worrying about their own well-being in retirement. The goal of guaranteeing workers' pensions does not mean that what workers receive in old age should be completely independent of all domestic or international outcomes. But it does mean that workers' pensions should not be subject to excessive risk, whether that risk is political or financial. The stipulation that workers' pensions be adequate means that they should replace a reasonable fraction of pre-retirement income — i.e., they should be consistent with lifetime consumption smoothing. So the adequacy of pension benefits is a relative, not an absolute concept.

There are two other critical aspects of guaranteeing adequate pensions for retirees. One is that the transactions costs that arise in delivering gross pension benefits be low. The other is that pension benefits be paid in the form of real annuities, so that retirees can neither run out of income nor suffer a real decline in their income if they live too long.

Lowering Tax Rates on Workers

Workers in a host of developing countries face exorbitant average and marginal social insurance taxes. These taxes are high not because their nominal rates are high, but because their effective rates are high. Their effective rates are high for two reasons. First, benefits are generally not closely linked at the margin to contributions. Second, there is often little likelihood that the additional benefits promised in exchange for additional contributions will actually be paid. Thus, lowering effective tax rates requires not just formally linking marginal benefits to marginal contributions but also making sure these benefits will be paid with a very high probability. The payoff from lowering effective tax rates comes in the form of increased labor supply, a reduction in economic inefficiency (what economists call *excess burden),* and increased participation by fringe workers in the formal sector.

Helping Achieve Intertemporal Fiscal Balance

The long-term fiscal imbalances of many developing countries are inextricably intertwined with the long-term fiscal imbalances in their pension systems. The basic problem in these countries is that their governments are bankrupt in a present value sense — they have committed to time-paths of pension payments, other social benefit payments, transfers, and debt service whose present value vastly exceeds the present values of their projected taxes. To cope with this imbalance, many of these countries effectively default on their pensions and other promises, including the wages they are paying government workers, by printing money and, thereby, reducing the real values of these payments. Although this policy lets these governments pretend they are meeting their obligations, no one is being fooled. Meantime, the economy is being put at grave risk because the government is undermining the means of payment.

To keep the public from substituting into hard currencies and, thus, nullifying their remaining channel of finance, governments, as most recently demonstrated by Russia, ban the use of hard currencies. In so doing, they also, in effect, ban foreign investment — an act of pure economic suicide. Why? Because banning the use of hard currencies means that foreign investors will be paid (but not necessarily on time) the return on their investments in domestic currency whose real value is subject to enormous uncertainty. This uncertainty arises because no one knows the degree to which the government will, for whatever reason, choose to debase the currency.

Pension reform holds the prospect of redefining the government's obligations so that it can actually fulfill, rather than effectively renege on, its promises. Stated differently, it holds the promise of realigning the present value of government receipts and expenditures so that the government will no longer need to resort to printing money to pay its bills. But the only way to ensure that any particular reform produces this outcome is to evaluate the government's pre- and post-reform fiscal finances in present value. This can be done by establishing a set of generational accounts, as roughly 30 countries around the world have done or are doing, or, more simply, by comparing the present values of future tax revenues and expenditures (including debt service). Armed with such a framework, one can quickly see whether any particular pension reform under consideration will mitigate or exacerbate the government's *intertempo-*

ral budget gap, defined as the excess, measured in present value, of projected future expenditures over projected future receipts. Reducing the government's intertemporal budget gap is a vital goal for pension reform because without the reform's contribution to fiscal solvency, it will be neither credible nor effective in delivering the benefits it promises.

The concern about the contribution of pension reform to overall fiscal solvency is often called the issue of *transition finance*. The key question concerning transition finance is whether during the transition to a new pension system, the reform provides enough sources of revenues to pay off, in present value, the benefit obligations that are recognized as part of phasing out the old system. Pension reforms generally redefine, in the downward direction, these obligations as well as the receipts to pay off these reduced obligations. Thus, transition finance analysis, when properly done, simply asks how the reform is affecting the government's intertemporal budget gap — whether the present value difference between the government's future expenditures and receipts rises or falls.

THE WORLD BANK'S PENSION REFORM GOALS

The World Bank certainly says that it shares the above goals. But its actions speak for themselves. These actions are guided by three additional goals that are fundamentally incompatible with the above set. These are fostering the development of (1) a capital market, including stock, bond, and mortgage markets; (2) a private pension industry; and (3) a private insurance industry. To achieve these ends, the Bank advocates that workers be forced to "save" by making contributions to domestic pension companies who will then use the funds to purchase domestic securities and domestic insurance products.

Now, in and of themselves, these additional goals are fine aspirations. What country would not want to have its own stock market, pension companies, and insurance industry? The problem is that the comparative advantage of Bolivia, Russia, Kazakhstan, and other Bank client countries is decidedly not in operating securities markets, running pension companies, or providing insurance. In propounding these goals, the Bank not only advises its client countries to pursue their comparative disadvantages, but it also coerces them to do so through the conditions it stipulates on its loans.

Countries like Kazakhstan, Bolivia, and Russia have much better things to do with their scarce resources. But instead of encouraging them to engage in free trade and to import the securities, pension administration, and insurance services they need, the Bank mandates that they turn a blind eye to reality — to the fact that there is an extraordinary efficient world securities market, pension industry, and insurance industry that awaits their beck and call.

The developed world produces the kinds of financial products a small developing country might produce, but at much lower cost. It also produces financial products that a small developing country is simply unable to produce, namely financial products that involve international risk diversification and the exploitation of economies to scale. One of these products is an internationally diversified portfolio with extremely low transactions cost. Another is an annuity insurance contract with very low loads and the pricing of mortality risk based on reinsurance — the ability of major insurance companies to hedge their risks via risk-sharing arrangements with other insurance companies. A third is pension administration that utilizes state-of-the-art computer technology developed at high cost because it would be used for a very large number of clients.

When confronted with their financial mercantilism, Bank economists utter four excuses:

✓ A large share of the pension assets arising from pension reforms need to be invested at home to maintain or increase domestic investment, and making these domestic investments requires the development of pension companies to collect and invest contributions, domestic securities markets to channel these investments, and domestic insurance companies to convert pension assets into retirement annuities.

✓ "Political reality" precludes "theoretical niceties," and investing abroad is simply a political non-starter.

✓ The difference between having all rather than a significant minority of pension assets invested abroad is not large, and the Bank advocates investing a portion of assets abroad.

✓ The terms of trade risk make investing all pension assets abroad too risky.

International Capital Mobility

None of these excuses holds water. First, from the perspective of an economically small developing country, the world capital market has gigantic stocks of capital that are available to import. Indeed, there is ample evidence that the world capital market waits with baited breath to invest in those developing countries which have transparent and sound economic policies. There also is ample and very recent evidence that, at a moment's notice, global capital will flee developing countries that do not have such policies. To grasp the size of the world capital market compared with that of a developing country's, note that current market valuation of the Russian stock market is less than the current market value of Home Depot — a single, relatively inauspicious U.S. company.

Instead of insisting that developing countries adopt sound and transparent policies (the most important of which is opening themselves up completely to direct foreign investment and competition in all areas of commerce, banking, finance, and insurance and adopting U.S. or EU regulatory, reporting, anti-trust, and supervisory laws and institutions), the Bank adopts the attitude that since its client economies are not going to open up, the Bank's job is to help them stay closed. Since the Bank takes financial market closure as a given, it concludes that the only way to increase domestic investment is through increased domestic saving. This is akin to telling someone dying of thirst to dig a well rather than sip from the faucet.

Political Reality and Theoretical Niceties

Second, the Bank has the power to create its own "political reality." It can either (1) make full international investment and diversification of pension assets a *sine qua non* for its approval of pension reform loans or (2) overcome any nationalistic objection to the full international investment and diversification of pension assets on grounds of reduced domestic investment by providing capital inflows, in the form of loans, that maintain, if not increase, the level of domestic investment. Furthermore, the art of politics is selling ideas. The idea of investing abroad in a fully diversified manner at low transactions cost with Western custodial arrangements should not be a hard thing to sell, if one tries. This is especially true if one is selling to a public, like the Russian one, that can otherwise look forward to being forced to invest at high transactions costs in highly risky domestic investments.

The Fixed Costs of Investing Pension Assets Domestically

Third, the difference between having all or most pension assets invested abroad is potentially huge not only for reasons of financial and political risk diversification but also because of the very considerable fixed costs of setting up and then regulating, supervising, and insuring (as lender of last resort) domestic securities markets, pension companies, and insurance companies. The moment a country decides, as part of its pension reform, to invest even one dollar domestically, it is forced to (1) establish pension companies to collect that dollar; (2) decide how to regulate and supervise those companies; (3) determine the securities in which the pension companies can invest; (4) regulate the market in the securities in which the pension companies invest; (5) specify how to annuitize the withdrawal by contributors of their accumulated pensions; and (6) regulate and supervise the insurance companies selling the annuities.

Moreover, in both advocating and enforcing less than 100 percent foreign investment and diversification of pension assets, the Bank signals to its client countries that is not particularly concerned about investing pension assets abroad. These countries take this signal to heart, so when it comes to pension reform, they mandate little, if any, international investment and diversification of their pension assets.

Many problems emanate from this decision. To begin, in many of the Bank's client countries, there are very few firms listed on the domestic stock exchange and an even smaller number of firms comprise the bulk of the stock market's valuation. Apart from the stocks and bonds of these firms, there are only two other assets — government debt and mortgages and other private loans — suitable for pension fund investments.

Hence, the Bank finds itself advising countries to risk large proportions of their workers' retirement incomes on (1) the fortunes of a handful of domestic companies whose future success is highly uncertain; (2) nominal government bonds that are subject to effective default via government-produced inflation; and (3) mortgages and other private loans whose repayment is also subject to great risk. To make matters worse, the return to domestic portfolios in developing countries is highly dependent on the performance of the overall economy — the same economy that determines the wages of pension contributors. Hence, putting workers' pensions in domestic assets ends up greatly compounding the risks they face on their human capital.

Bank staff are not entirely oblivious to these problems. They refer to them when they worry out loud that the *financial preconditions* for pension reform (as they define such reform) are "inappropriate." In response, they modify their standard approach to pension reform by either (1) requiring that, at least in the short run, the bulk of pension fund assets be invested in government bonds or (2) abandoning entirely the privatization of the pension system and installing a *notional* pension system that continues to leave the country saddled with a pay-as-you-go system, albeit one that may be less expensive and that provides better linkage between marginal pension contributions and marginal pension benefits.

Real Exchange Rate Risk

Fourth, for most Bank client countries, improvements in real exchange rates are positively correlated with the economy's performance. Hence, investing abroad provides an opportunity to hedge real exchange rate risk. For example, when the real exchange rate is high and the economy is performing well, the relative value of one's foreign assets will be low because of the appreciation of the exchange rate, whereas when the real exchange rate is low and the economy is performing poorly, the relative value of their foreign assets will be high because of the depreciation of the exchange rate.

Moreover, even if the correlation between a country's real exchange rate and its economic performance is negative, the gains from international diversification and investing at low transactions costs would almost surely outweigh any risks to foreign investment arising from real exchange rate movements. Compare, for example, investing in the stocks and bonds of a handful of companies in Bolivia with investing in the stocks and bonds of the thousands of major companies of the world and the bonds of all of the world's developed and developing countries.

The World Bank's Approach to Pension Reform

The Bank's approach to pension reform has the following 10 elements:

1. Promise workers benefits accrued under the old system. In defining these benefits, raise the old system's retirement ages and reduce the generosity of the benefit formula.
2. Reduce workers' payroll taxes and mandate that they contribute all or a portion of their payroll tax cuts to individual pension accounts.
3. Establish competing domestic pension companies to accept and invest workers' contributions.
4. Require that pension companies invest the bulk of their deposits domestically — in government bonds, private bonds and mortgages, and the local stock market.
5. Permit pension companies to compete with one another for contributions.
6. Establish a high, non-earnings related minimum pension benefit to protect workers against low or negative rates of return earned by their pension companies.
7. Pay for the minimum pension benefits on a pay-as-you-go basis.
8. Establish regulations to supervise the operations of the pension companies and the domestic securities market.
9. Permit governments to deficit-finance their transitions to the new system without checking the implications of this policy for the government's intertemporal budget gap.
10. Allow individuals to take their benefits in non-annuitized form in old age or to purchase annuities on their own.

Problems with the World Bank Approach

The Bank's approach to pension reform has as many problems as it has features. Most of the problems, many of which have already been mentioned, stem from the Bank's insistence on investing pension fund assets at home.

The Bank's Insistence on a Minimum Pension

The Bank includes a minimum/basic pension as part of its standard pension reform package. Why? Because it knows that the domestic investment of pension fund assets that it also is promoting is extremely risky and could easily turn sour. Consequently, it feels compelled to protect retirees with respect to just such an outcome by insisting on a high minimum benefit. To make matters worse, the Bank encourages countries to finance their minimum benefits on a pay-as-you-go basis. In so doing, the Bank is installing essentially the same kind of system the country desperately needs to eliminate. In the long run, the country still has a high payroll tax or some other tax that is financing the high minimum benefit. In addition, there is no linkage, at the margin, between the taxes workers pay for the minimum benefit and the size of this benefit — all workers get the same benefit regardless of their earnings.

This rear guard action by self-styled Bank reformers to preserve the status quo is dubbed the *first pillar* of a three-pillar system, in which the *second pillar* is a privatized pension program, and the *third pillar* is voluntary occupational pensions. Unfortunately, the first pillar is a real killer. It not only kills the prospect of ever truly escaping pay-as-you-go finance of government pensions. It's also used to excuse a very high degree of extremely risky domestic investment in the "privatized" second pillar.

Fiscal Malfeasance in the Name of Pension Reform

The term "privatized" certainly deserves quotes here. The preponderance of government debt in the portfolios of the newly created pension companies in countries that adopt the Bank's approach raises the question of whether the entire reform is simply an elaborate shell game. In this putative shell game, workers, in the new regime, make contributions to their pension funds, rather than to the government, and the pension fund turns around and gives the contributions right back to the government as loans. So the cash flow from the workers to the government remains the same. In the old system, workers receive implicit I.O.U.s to future government pension benefits in exchange for their contributions, whereas under the new system they receive, via their pension funds, explicit I.O.U.s (government bonds) that promise to pay interest and principal.

If the implicit and explicit I.O.U.s have the same present value, then the "reform" has not reduced the present value of the government's future expenditures — it has simply relabeled them. Of course, the typical pension reform also involves changes in the present value of future government receipts. If this present value is also left unchanged by the reform, the entire enterprise will, from the perspective of the government's intertemporal budget gap, be just a shell game.

Bank-supported reforms typically include significant reductions in the accrued benefits paid to workers under the old system. Indeed, the Bank has, over the years, developed a sophisticated software package, entitled PROST, to calculate precisely how much benefit obligations are reduced by pension reform. So Bank-supported reforms are certainly not shell games. Unfortunately, once one takes account of the receipt side of the ledger, Bank-supported reforms may be worse than shell games, at least from the perspective of the government's intertemporal budget gap.

The problem is that the Bank does not check whether the present value of receipts arising from its reform rises or falls, and, if it falls, whether it falls by more than does the present value of expenditures. To do this, one needs to consider the change in the present value of all government receipts arising from the reform, not just the change in the present value of payroll taxes that directly finance pension benefits. Unfortunately, the PROST model is not yet equipped to handle all government receipts.

Why does one need to understand the change in the present value of all receipts? The reason is that, over the short and medium runs, Bank-supported pension reforms typically involve deficit finance of the difference between the benefits payable by the old (pre-reform) pension system and the reduced payroll tax receipts. If the interest and principal on this new debt issue is repaid with tax revenues, rather than simply borrowed, those tax revenues will most likely be general revenues, such as income taxes or value-added taxes.

Since the Bank is not able to check how much of the newly issued debt is to be repaid, it is not able to say whether the reform is reducing or increasing the client-country's intertemporal budget gap. Worse, since the Bank itself is not able to check, it does not require the client country to check either. Nor, apparently, does it bother telling the client country that the debt it issues in the course of reforming its pension system needs to be repaid; in other words, that the country needs to dedicate a stream of either (1) future general revenue, (2) future payroll taxes in excess of benefits payable under the old system, or (3) future spending cuts to cover this debt. In doing and not doing all these things, the Bank is encouraging and promoting fiscal malfeasance of the first order. Worse yet, the Bank is lending its clients the funds to engage in this malfeasance.

Kazakhstan — An Example

Lest this accusation of fiscal irresponsibility be viewed as a figment of the author's imagination, consider the Bank's recent loan of roughly $100 million to the Kazakhstan government in support of its pension reform. The Kazakhstan reform features an immediate 10 percentage-point cut in the 25 percent payroll tax funding pension benefits with another 10 percentage-point cut to be made over the following 10 years. The reform also entails a modest increase in the existing system's retirement age and some reduction in the accrued benefits owed to existing workers for service under the old system. These benefit cuts notwithstanding, because of population aging, Kazakh aggregate real pension benefits are projected to remain essentially unchanged over the next quarter of a century according to the Bank's own benefit projections.

How is the huge loss in payroll tax revenues to be recouped so that Kazakhstan can pay these pension benefits? The answer is borrowing — borrowing from the new pension funds as well as borrowing from the Bank, the IMF, and the Asian Development Bank. The amount of this borrowing is projected by the Bank to accumulate, in short order, to roughly 40 percent of Kazakhstan's gross domestic product (GDP). To put this figure in perspective, this is approximately the ratio of official government debt (measured by the sum of past National Income International Monetary Fund, and Asian Development Bank supporting a policy that will, over the space of a few years, encumber Kazakhstan with as much debt (relative to its GDP) as it took the United States over two centuries to accumulate!

The Bank's stated rationales for this policy are (1) that Kazakhstan can afford this level of debt given its prospective oil and related revenues and (2) the cuts in payroll taxes will stimulate labor supply in the covered sector and expand the tax base. Hypothetical oil revenues and extreme supply-side economics are not a basis for risking a nation's fiscal solvency. Kazakhstan can ill afford reckless fiscal policy, which is precisely what the World Bank is endorsing.

The Bank's Investment Advice — An Analogy

In the case of Kazakhstan, pension assets that are not immediately handed back to the government as loans are to be invested in the stocks and bonds of Kazakh firms and other domestic assets. Kazakhstan is certainly a large country, but the contributions that its workers will make to their pension funds appear to be less than those that are made each year to the California state pension plan that covers state employees. To put the Bank's investment advice in perspective, consider how the Bank would advise the State of California to invest its pension assets. The answer is that it would tell the state to invest only in California companies. In so doing, the Bank would preclude investing in General Motors, Coca Cola, Microsoft, Toyota, Pierre Cardin, British Airways, Siemens, and the thousands of other major companies throughout the developed and developing world that are not headquartered in California. This would seriously jeopardize the central goal of providing California state workers with reliable pensions. State employees would not stand for it, and trustees of the state's pension system would be sued for dereliction of their fiduciary responsibilities.

Letting Workers Use Their Pensions to Try to Beat the Market

Regardless of whether the Bank forces workers to invest domestically or internationally, there is no reason to establish a set of pension companies who compete with one another to "beat the market." By definition, not everyone can beat the average. So placing workers in pension funds that hold different assets is a prescription for increasing the inequality in their accumulated pension wealth and, therefore, in their retirement living standards. The simple way around this problem is to require that all workers' pensions be invested in the same portfolio. But in this case, one does not need a pension industry to invest pensions or to pay the high fees, bid-ask spreads, and other charges collected by top money managers. One simply needs to hire a computer.

There is ample evidence from the United States and other developed economies that the private annuities market does not function well and has very few participants. Letting workers cash out their pensions in non-annuitized form is an invitation for them to cash out too soon and run out of income if they live longer than they expect. Leaving workers to purchase annuities from the private insurance market when they retire is an invitation for them to lose a significant fraction of their old age resources in the form of insurance loads. The World Bank is issuing both invitations in adopting its laissez-faire attitude about withdrawing pension account balances in old age or purchasing annuities from the private insurance market.

THE PERSONAL SECURITY SYSTEM

Having complained at length about the Bank's approach to pension reform, it is time to present a straightforward and sensible alternative entitled the Personal Security System (PSS). The PSS has the following features:

✓ Maintains benefits for current retirees.

✓ Abolishes current pension system at the margin, but provides workers in retirement the benefits they could reasonably expect to have accrued under the old system. This is much less than what they were being promised by the old and bankrupt system.

✓ Mandates that workers contribute a fixed percentage (for example, 8 percent) of their wages to Personal Security Accounts.

✓ For married workers, allocates half of their contributions to their own accounts and half to their spouses'.

✓ The government matches workers' PSS contributions on a progressive basis and makes contributions on behalf of disabled workers.

✓ All PSS contributions (and the government matching contributions) are invested in (1) special issue PSS bonds and (2) a market-weighted global index fund of stocks, bonds, and real estate.

✓ In the short run, World Bank and International Monetary Fund assistance, as well as proceeds from privatization, would be used to pay for benefits owed to retirees. Hence, in the short run, all workers' contributions would be invested in the global index fund. This would dramatically improve incentives for working in the formal sector and paying taxes.

✓ When a birth cohort reaches age 60, its accumulated PSS account balances are gradually transformed into inflation-protected pensions. Each day, until the cohort reaches age 70, a portion of the cohort's outstanding balances are converted to pensions. Each member of the cohort receives a pension in proportion to its share of the cohort's collective balances.

✓ Workers who die before age 70 bequeath their non-annuitized account balances to their spouses, children, or other designated beneficiaries.

✓ Benefits owed under the old system are financed by (1) maintaining some part of the payroll tax; (2) paying current workers their accrued, rather than their projected, government pension benefits in retirement; (3) cutting or limiting the growth of government purchases; and (4) using grants from the World Bank and the International Monetary Fund. A detailed intertemporal budget gap analysis would be undertaken to ensure that the reform ends up significantly reducing the gap on balance.

✓ Once the transition is complete, the payroll tax dedicated to financing the transition is eliminated. Short-run cash-flow deficits during the transition are covered by the issuance of special-issue, inflation-protected, 3 percent government PSS bonds. At the end of the transition, these bonds are completely retired.

✓ The level of the dedicated payroll tax is set to ensure that, over the transition period, the present value of all revenue sources equals the present value of pension benefit payments due under the old system. Discounting is done at the 3 percent real rate paid by the PSS bonds. This ensures that at the end of the transition period, the dedicated payroll tax will be eliminated. This financing scheme determines at each date the amount of special-issue PSS bonds that need to be purchased by the PSS Trust. Any and all residual account balances held by the PSS Trust will be invested in the global index fund.

✓ Workers receive quarterly PSS account statements. The PSS accounts represent private property. Contributions to PSS accounts are not subject to income taxation, but withdrawals from PSS accounts are subject to income taxation. This affords consumption-tax treatment to these accounts.

✓ The government puts out to international bid the separate jobs of (1) collecting PSS contributions and paying out PSS pensions; (2) investing PSS contributions in PSS special issue bonds and the global index fund; and (3) converting PSS accumulated account balances into inflation-protected pensions.

Advantages of the PSS Reform Proposal

The Personal Security System improves benefit-tax linkage, protects nonworking spouses, improves intra- and inter-generational equity, resolves the existing pension system's long-term funding problem, and ensures workers a very high level of retirement income. In setting its matching contributions, the government can make the PSS system as progressive as it wants. By investing abroad in the manner recommended, workers become fully diversified across the world and pay extraordinarily low transactions fees. The country also develops a reputation for having a fully open capital market that will encourage foreign direct and financial investment. By requiring collective annuitization of each birth cohort's account balances, the PSS avoids adverse selection, high insurance fees, and the problem of the elderly running out of income in old age. In the long run, countries adopting the PSS plan will succeed in eliminating an extremely onerous payroll tax that reduces the ability of young people to save and lowers their incentive to work.

CONCLUSION

When it comes to pension reform, the World Bank has too many contradictory goals that collectively lose sight of the ultimate rationale for a state-run pension system, namely insuring and ensuring the retirement income of the nation's workers. The Bank has not only relegated this primary goal to a secondary status, but it has also encouraged and led countries to engage in pension reforms that are, fiscally speaking, breathtakingly irresponsible. It is time for the Bank's top management to reassess this policy on its own terms, but also in light of the availability of a straightforward alternative — the Personal Security System — that can readily be implemented and that achieves all the legitimate goals of pension reform.

THE ROAD TO THE GREAT EXPANSION

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I. INTRODUCTION

The United States has sustained nearly continuous economic growth since 1983. This "Great Expansion," the longest economic expansion in U.S. history, has:

✓ boosted industrial production 79%;

✓ increased real gross domestic product (GDP) 81% (3.6% annual growth);

✓ increased real per capita GDP 54% (2.6% annual growth); and

✓ created 35 million new jobs (net).

Today, the United States enjoys strong productivity growth, low inflation and minimal unemployment.

Twenty years ago, the United States faced an entirely different economic situation. Inflation and unemployment had risen to unacceptable levels. The economy was in recession. Productivity was falling, and real incomes were falling even faster.

The Keynesian thinking which had dominated economic policymaking in Washington for decades could not explain, much less cure, the economic turmoil. According to Keynesian theory, the way to reduce inflation was to reduce aggregate demand, thereby raising unemployment. The way to reduce unemployment was to boost aggregate demand, thereby raising inflation. With both inflation and unemployment high and rising, what was the federal government to do?

Former Governor Ronald Reagan campaigned for the presidency in 1980 with a simple message: "In this present [economic] crisis, government is not the solution to our problem; government is the problem."

II. RONALD REAGAN'S ECONOMIC PROGRAM

The first thing Ronald Reagan did was dismiss the old "Phillips Curve" notion that there existed some necessary tradeoff between inflation and unemployment. He maintained that federal policies were distorting price signals, imposing heavy costs on producers, and leading people to work, save, and invest less than they would have otherwise. Correcting those policies, he argued, would boost economic growth and reduce both inflation and unemployment over time.

The centerpiece of Ronald Reagan's economic plan was his proposal to cut taxes. Not only was Reagan proposing the largest tax cut in American history, but he was proposing to cut taxes at the margin — that is, on the last dollar each taxpayer earns. Marginal tax rates are important because people make decisions at the margin. Decisions to work an extra hour or to save an extra dollar are strongly influenced by the after-tax return associated with the additional effort. These decisions affect the aggregate supply of labor and capital.

Throughout the 1970s, policymakers neglected the distinction between average and marginal tax rates. Thus, whenever Congress debated cutting taxes, it would invariably consider tax rebates or temporary tax cuts meant to boost aggregate demand. Many lawmakers preferred those short-term tax cuts because Congress could provide them without sacrificing future tax revenue. Unfortunately, those kinds of tax cuts did nothing to improve the tax incentives to work, save, or invest at the margin.

Among other things, high marginal tax rates distort the relative price of saving versus consumption. For example, if you have $10,000, you can either consume it or save it for the future. If you could earn 10% interest, saving the $10,000 would produce $1,000 in interest (assuming no tax on interest income). Consuming the $10,000 would preclude your ability to consume $11,000 next year. If, however, the government imposes a 90% tax on interest income, you would sacrifice only $10,100 next year to consume $10,000 this year. The tax has reduced the relative cost of consumption. All else equal, this distortion will induce people to save and invest less than they would have otherwise. Reagan's marginal tax rate reductions would do much to lessen this distortion.

As inflation rose in the 1970s, Americans increasingly suffered from "bracket creep." In other words, as inflation boosted nominal incomes, the tax code pushed taxpayers into higher tax brackets — even if their income had fallen in real terms. Bracket creep steadily undermined incentives to work, save, and invest. Ronald Reagan called upon Congress to index the federal income tax for inflation.

Besides cutting and indexing taxes, Ronald Reagan's economic program included (1) paring federal regulations that were raising production costs and hampering economic efficiency; and (2) reducing and *restructuring* federal spending as a share of GDP to release real resources to the private sector.

This was very different from the "government-knows-best" approach Reagan inherited from the Carter administration. "Government's view of the economy," Reagan quipped, "could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it." Reagan rejected those policies and instead sought to create an environment conducive to economic growth.

III. IMPLEMENTING REAGAN'S ECONOMIC PROGRAM

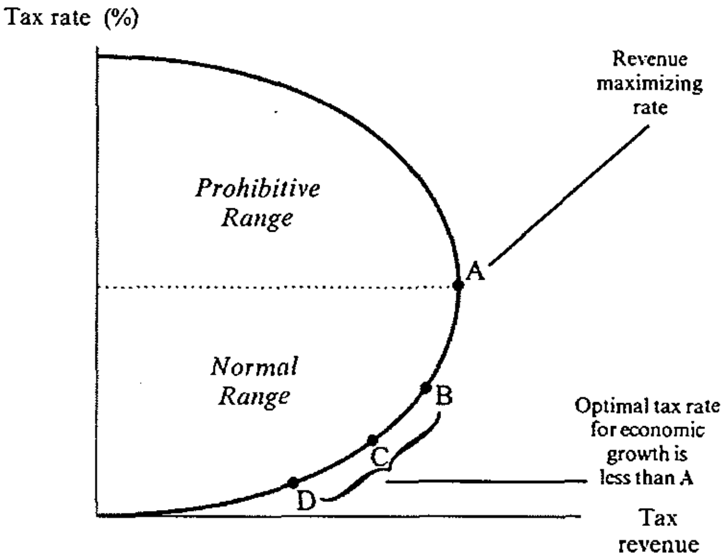
Having unexpectedly captured the Senate in the 1980 elections, Republicans formed an informal coalition with conservative Democrats in the House of Representatives to push a compromise version of President Reagan's economic program through Congress.

President Reagan's critics predicted his policies would lead the country to economic ruin. They said his tax cuts were inflationary. They said his spending cuts were draconian. They ridiculed his economic assumptions. In short, they did everything they could to undermine the President's credibility.

The President's critics routinely exaggerated what the Administration claimed its policies could accomplish. In doing so, Reagan's critics made it difficult for the Administration's economic program to meet expectations. For instance, Reagan's critics attacked the President for supposedly claiming that his tax cuts would "pay for themselves." The President, however, never made that claim. Intentionally or not, Reagan's critics had developed a twisted understanding of the Laffer Curve.

The Laffer Curve is based on the principle that taxes discourage productive activity. A tax rate of 100% discourages all productive activity (and therefore collects no revenue); a 0% rate simply collects no tax revenue. Lowering the tax rate from 100% reduces the disincentives to work and generates some tax revenue. Further reductions in the tax rate will raise additional revenue until the rate falls below the "prohibitive range," where a lower rate encourages additional productive effort but loses more tax revenue than it gains. The trick is for lawmakers to find a tax rate that minimizes the dampening effects of taxes while collecting sufficient revenue to operate the government.

When Ronald Reagan assumed the presidency, the federal income tax code featured fifteen steeply graduated tax brackets ranging from 14% to 70%. The



President proposed reducing the marginal rates associated with all fifteen brackets — cutting the top marginal tax rate from 70% to 50% and the bottom rate from 14% to 11%. The marginal after-tax reward for those in the top tax bracket would therefore increase from 30 cents to 50 cents (a 66% increase) on the dollar. Taxpayers in the bottom bracket would see their marginal after-tax reward rise from 86 cents to 89 cents (a 3.5% increase) on the dollar.

Upper-income taxpayers responded to the reduction in their marginal tax rates by working and saving more than they would have otherwise. They also sheltered less of their income from taxes. Ultimately, the marginal rate cuts in the upper brackets paid for themselves and the share of total tax revenue paid by high-income earners increased. As expected, the rate cuts in the lower brackets substantially reduced overall revenue.

IV. THE FEDERAL RESERVE'S REACTION TO REAGAN'S TAX CUTS

Because Keynesian theory held that the primary effect of cutting taxes was to boost aggregate demand, many policymakers thought Reagan's tax cuts would lead to greater inflation. It was obvious during the previous decade that policymakers had lost sight of the fact that inflation is always and everywhere a monetary phenomenon — too much money chasing too few goods.

In the late 1960s, the Federal Reserve abandoned its commitment to price stability and sought to stimulate the economy with a loose monetary policy. When inflation began to rise in 1968, the Johnson administration adopted a tax surcharge to temper demand and combat inflation. Nonetheless, inflation more than doubled from 3% in 1967 to 6.2% in 1969.

President Nixon continued the war on inflation by imposing price and wage controls in 1971. The controls failed to extinguish inflation, but they distorted relative prices and caused shortages throughout the economy. Inflation rose to 8.7% in 1973 and to 12.3% in 1974.

Inflation remained a problem throughout the 1970s, peaking at 13.3% in 1979. It was not until the Federal Reserve renewed its commitment to price stability in the early 1980s that inflation abated.

President Reagan's economic program assumed a gradual reduction in inflation. More precisely, the Administration assumed inflation would fall from 12.5% in 1980 to 7% in 1982 and to 4% in 1986. The Administration prepared its first budget using these assumptions.

Acting on the mistaken assumption that Reagan's tax cuts would aggravate inflation, the Federal Reserve clamped down hard on monetary policy — pushing the interest rate on bank reserves above 19% by June 1981. Inflation unexpectedly collapsed from 12.5% in 1980 to 3.8% in 1982 and the economy fell into recession. The combination of these two developments pushed GDP and tax revenues significantly below projections. Although Congress had adopted an especially frugal budget in nominal terms, the collapse in inflation boosted real outlays far above what Congress had intended. With revenue falling relative to projections, and with real outlays rising relative to projections, the federal budget deficit ballooned.

V. THE OBSESSION WITH THE BUDGET DEFICIT

Overnight, the budget deficit became an important political issue. It was to dominate political discourse in Washington for nearly two decades.

The budget deficit was sizeable, but it was not nearly the economic problem Congress thought it was. The consensus in Washington held that budget deficits would raise interest rates and thereby "crowd-out" (displace) private investment. In turn, less private investment would reduce productivity growth and undermine the country's ability to improve its standard-of-living over the long-term.

The consensus was wrong. First, unless monetized, budget deficits do not raise interest rates. The evidence supports this. Second, deficits do not crowd-out private investment. Government spending crowds-out private investment.

Borrowing is just another means of reallocating private resources for public use. It does not matter in this regard whether the government takes $1 in taxes or borrows $1. Either way, those resources are withdrawn from the private sector.

The country's obsession with the deficit made it politically difficult for Congress to boost federal spending and grow the size of government. But that didn't stop Congress. To combat the deficit, Congress passed a series of tax increases (1982, 1983, 1984, 1990, 1993). Rather than reduce the deficit, these tax increases merely gave the government the means to spend more than it could have otherwise. In fact, the congressional Joint Economic Committee analyzed historical budget data and found that for every $1 the government increased taxes in the 1980s, it spent an additional $1.59.

As part of its effort to combat the budget deficit, Congress erected several procedural hurdles to deter new spending. Yet, with each procedural change, Congress devised new and innovative ways of circumventing the system. This included manipulating budget numbers and employing gimmicks. For example, rather than terminate questionable military procurement programs, Congress would routinely stretch-out the production schedules, reducing outlays (and the deficit) in the short-term but raising the cost of the equipment (and the deficit) in the long-term.

Congress also embraced new legislative rules to make sure that any changes it made to the tax code were at least revenue-neutral under static scoring. Static scoring is based on the unrealistic assumption that changes in tax incentives do not affect taxpayer behavior. To highlight the ludicrousness of static scoring, Senator Bob Packwood once asked Congress' Joint Committee on Taxation (JCT) to calculate the revenue impact of raising the marginal income tax rate on taxable income above $100,000 to 100%. The JCT responded that doing so would raise $2 trillion in additional tax revenue over five years. In other words, the JCT assumed people would continue to work in spite of a 100% marginal tax rate. Static scoring consistently overestimates the revenue to be gained from tax increases and lost from tax cuts.

With the end of the Cold War, and the subsequent reduction in U.S. defense outlays from 6% to 3% of GDP, the federal budget moved into surplus in 1998 — the first surplus in nearly thirty years. Based on the strength of the economy, forecasters are currently projecting the fiscal 2000 surplus to exceed $200 billion.

VI. CONCLUSION

The recent budget surpluses and the Great Expansion are, in part, products of Ronald Reagan's economic policies and the Federal Reserve's firm commitment to price stability. Without such a foundation, the technological and productivity gains seen in the last decade would, without question, have been much less prolific. The road to economic reform may be bumpy, but prosperity can be a reality if the policies for creating an environment conducive to economic growth are in place. These policies include:

- ✓ sound money / stable prices;
- ✓ legal institutions committed to protecting private property and enforcing contracts;
- ✓ an openness to international trade;
- ✓ a reliance on markets; and
- ✓ small government (low expenditure to GDP ratio, few regulations, and low taxes).

These policies work in the United States and throughout the world. They will work for Russia. Russia can enjoy its own Great Expansion.

The collection of policy papers contained in this publication were first presented in Moscow to the Russian public and the economic community in April 2000.

The authors of these policy papers are all leading international economists and policy makers who were invited to Moscow to share their experiences and expertise with Russian analysts working on economic policy issues at the Center for Strategic Research (CSR). The CSR is a non-governmental institution, comprised of representatives from various Russian Think Tanks. It was created in December 1999 at the initiative of then Acting President Vladimir Putin.

The papers presented here reflect various aspects of the high-level policy dialogue that is taking place in Russia today. This dialogue presents a unique opportunity to inform the public discussion with respect to economic policy. This dialogue will also help stimulate a closer link between economic thinkers and policy-making officials.