Chapter 8

Policy Reforms and Growth Performance: What Have We Learned?

THIS CHAPTER SYNTHESIZES THE lessons from the review of experience with policy reform in macroeconomics, trade, privatization, and finance. As the preceding chapters illustrate, each of these areas of policy reform is complex and an attempt to draw lessons in any one of them creates vigorous debate. Nevertheless, three key cross-cutting lessons seem to emerge:

- Most market-oriented reforms have had positive payoffs, though their impact on growth was not as large as some of the exorbitant claims made both in academic and policy circles.
- Experience shows the importance of creating institutional constraints on the exercise of discretion in policy implementation. Institutions and rules should be seen as a means to facilitate the predictable, credible, and beneficial use of discretion, rather than as a substitute for discretion.
- The expectations of the various actors in the markets play a crucial role in the success or failure of reforms, and their evolution can lead to either virtuous or vicious circles in the reform process.

These lessons are discussed in section 1. They create three suggestions for a way forward, examined in section 2:

- While the basic economic principles behind most of the reforms of the 1990s were correct, there was a tendency to believe that they could only be implemented in certain ways. Going forward, more emphasis is needed on common principles, along with a more pluralistic approach to implementing those principles.
- Growth strategies, focused on initiating and sustaining episodes of rapid growth, are the key to reaching much higher levels of income. Such strategies focus on attacking the binding constraints on growth, rather than addressing many weaknesses simultaneously.
- Creating the institutional conditions for a favorable climate for investors, both large and small, is essential. Government actions and their design should be scaled to match the country's institutional capability. "Do no harm" is a wonderful guide, and the potential for government action to improve on market outcomes needs to be balanced against the ability of existing institutions to sustain good practices.

1. Cross-Cutting Lessons of the 1990s

For each of the three cross-cutting lessons, this section uses a common organizational structure: it diagnoses previous successes and failures, reviews the conventional wisdom of the 1990s that lay behind the reform efforts, and describes the lesson itself.

Lesson 1

Most market-oriented reforms have had positive payoffs, though their impact on growth was not as large as some of the exorbitant claims. And the benefits of reform were, in general, predicted correctly by microeconomists and sectoral experts, though not by crude applications of the "new growth" theory.

Diagnosis before the 1990s: Conflicting Interpretations of the Relationship of Growth to Policy

Understanding the lessons of the 1990s for economists requires a little background on the professional state of play in the early 1980s. At that time, growth theory was still dominated by the Solow-Swann model (Solow 1956, 1971; Swann 1956). According to that model, in the steady-state equilibrium, long-run growth rates are completely unaffected by national policies. That is, while national policies could affect the *level* of income they could not permanently affect the *growth rate*.[1] Meanwhile, the analysis of sectoral reforms—for example in trade, privatization, or the financial sector—was dominated by microeconomic models in which gains resulted from policy reforms but were typically only small fractions of the gross domestic product (GDP).[2]

This match—of the unresponsiveness of long-run growth rates to national policies in macroeconomics, and the apparently small efficiency gains to be had from sectoral reforms in microeconomics—was a stable but increasingly unhappy marriage. Stable because these were both very robust features of their respective analytical approaches. Unhappy because by the early 1990s this combination of approaches clearly could not explain some basic facts about the world, particularly the developing world:

- Since some countries are very rich and others are very poor, differences in growth rates must have been sustained and substantial. Indeed, as chapter 2 showed, growth rate differences of nearly 2 percentage points a year have been sustained for more than 100 years.
- The differences in growth rates across countries over periods of a decade or more were too large to be "steady-state" differences, but they also seemed too large to be transitional differences in adjusting to efficiency gains.
- Countries' growth rates change dramatically: some countries have growth rates that propel them rapidly out of poverty traps while others go from rapid growth to stagnation or bust.

Conventional Wisdom in the 1990s: "New Growth" Theory and Large Gains from Reform

This inability of the standard theory of steady-state growth to explain the facts perhaps explains the love affair of academic and policy-making circles with "new growth theory" models in the 1980s. Advances in the modeling of noncompetitive equilibria (Romer 1983, 1986) allowed the development of a new set of endogenous growth models in which national policies could influence not just the level of income but also countries' steady-state growth rates (Grossman and Helpman 1992; Aghion and Howitt 1998). These led to the conventional wisdom of the 1990s—that policy reform could affect economic growth—but they never made quite clear why this should be so. Often, authors did not make clear whether their growth regressions were intended to identify differences in steady-state growth or, instead, to identify impacts of policy on the level of income. Such lack of clarity pervades discussions of growth. It is useful to dispel this confusion by keeping the gains in levels with "growth" as a transitional phenomenon and gains in "growth" in the steady state. In the end, the hope was dashed that there were large policy-driven gains in *steady-state* growth. Even so, this does not imply that policy reform cannot yield large growth gains when it has a large impact on the *level* of income.

Trade policy reform illustrates this point. Many growth regressions related growth in output per person in the i*th* country over some period of n years to the lagged level of output and some indicator of trade policy during some period:

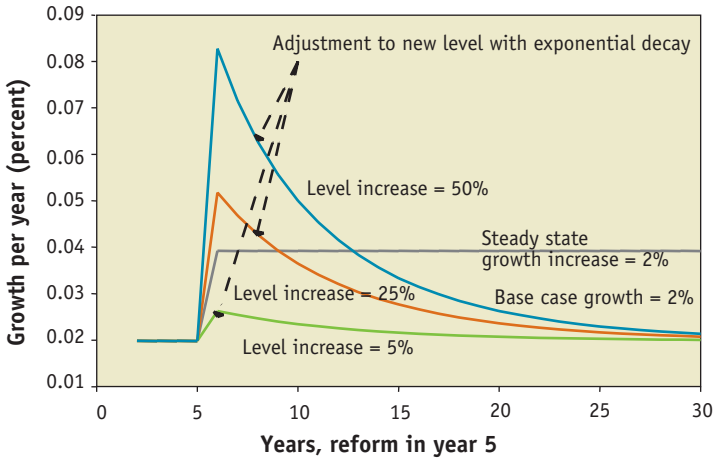
$$g^i_{t,t-n} = y^i_t - y^i_{t-n} = \alpha + \lambda \star y^i_{t-n} + \beta \star Trade\ Polic + Other\ \ factors + error\ term$$

Figure 8.1 shows the path of annual growth stemming from a hypothetical trade reform that increases the sustainable level of output. Let us assume for now that "trade policy" at any point in time can be adequately represented by a single number. The graph shows a hypothetical economy growing at a steady-state rate of 2 percent a year. In year $t = 5$ there is a permanent improvement in trade policy from TP to TP⋆. If trade policy raises the *steady-state* growth rate immediately and permanently by 2 percentage points, the measured growth rate over any five-year period will increase from 2 to 4 percent and will remain at that higher level. In this case the impact of the trade reform on the *level* of output will be infinitely large.

Figure 8.1 also shows the impact of a trade reform that affects only the *level* of output. In each case we assume some dynamics for illustration—that the impact on the level of output takes 10 years to be fully felt and that the adjustment from the baseline to the higher level of output is linear. In this case, the reform has an impact on measured five-year growth rates that increases as output adjusts to its new level, and then decreases to zero; that is, the economy returns to its steady-state growth path. The graph shows the impact on annual growth rates of a trade reform, using three possible magnitudes of the cumulative impact of the reform on the level of output: 5 percent, 25 percent, and 50 percent (under certain assumptions about adjustment dynamics). If the cumulative impact of the trade reform on the equilibrium level of output is only 5 percent, the impacts on measured growth rates are small and disappear quickly, compared to the impact of a 2 percentage point increase in steady-state growth rates. In contrast, if the cumulative impact of trade reform on the level of output is 25 percent, over a 10-year horizon the effect of the reform on the observed growth rate is virtually indistinguishable from the effect of an increase in the steady-state growth rate—and only over long periods does it become possible to distinguish one (an impact on level with transitional growth) from the other (an increase in steady-state growth). Finally, if the impact of the trade reform on the equilibrium *level* of output is as large as 50 percent, the impact on observed five-year growth rates is much larger for a reform that "only" affects the level than it is for a reform that has a large impact on steady-state growth.

FIGURE 8.1

Simulated Impacts of Policy Reform on the Level and Growth Rate of Output



This technical excursion clarifies that over the horizon of a decade or more the impact of an economic reform on observed growth rates does not depend at all on whether the reform raises steady-state growth or "only" raises the long-run level of output with no impact on steady-state growth. What matters is the size of the gain and the speed of adjustment. Over the medium term, if the effects on the level of output are small, the effects on steady-state growth will also be small, and if the effects on the level of output are large, the effects on growth will be large.

Whether growth regressions in the 1990s were estimating growth effects or level effects mattered less than how the regressions were interpreted. In practice they were widely seen as producing estimates of gains from policy reform that were whole

orders of magnitude larger than the microeconomic estimates of those gains. The example of trade liberalization again illustrates this point. The original microeconomic ("Harberger triangle") estimates of the welfare gains were on the order of 1 to 5 percent of GDP for an ambitious reform of tariffs from moderately high levels. With moderate adjustment speeds, such a reform would increase growth rates temporarily by not more than half a percent a year. Even when models introduced general equilibrium effects and plausible links from trade reform to productivity improvements, the apparent gains from trade reform were too small to cause sustained growth increases of more than 1 percent a year, over a period as long as a decade. By contrast, it was frequently claimed that growth regressions, such as those of Sachs and Warner (1995), supported the view that trade liberalization could raise the rate of economic growth by 2 percent a year over a 30-year horizon. This implies a rise of 80 percent in the level of output. Even if trade policy reform were to raise the economic growth rate by only 1 percent a year, sustaining these effects for a very long period—as implied by the very small adjustment coefficients—would produce gains of as much as 50 percent of GDP.

Interpreting the "aggregate" and "growth regression" evidence concerning the impacts of trade policy on output is nearly impossible, because even though many studies take growth as the variable to be explained, the interpretation of the magnitude of the resulting coefficient depends entirely on how the dynamics of the regression are specified: the same reported coefficient on a variable representing trade policy could imply either a small or an infinitely large effect on the level of output.

Lesson of the 1990s: Policy Reform Produced Mixed, and Modest, Gains

The 1990s showed that the long-run impact on output[3] of most policy reform actions in the areas considered—macro, trade, privatization, financial liberalization—was positive and roughly as large as claimed by microeconomic or general equilibrium studies.

In particular, from most microeconomic-based models we would expect that the gains would be larger, the larger the initial policy distortion, because the welfare gains from distortions increase as the square of the distortion. Chapter 5 emphasized that countries that made very large reductions in tariffs (Bangladesh, India, Pakistan) achieved large gains in integration, while those that made smaller reductions in tariffs achieved smaller gains. Similarly, chapter 4 showed that the potential gains from taming hyperinflation are much larger than the potential gains from reducing inflation from more moderate levels. And in the financial sector, the gains from interest rate liberalization depend on the severity of the initial financial repression: thus for countries with very negative real interest rates, liberalization should produce large gains, while for countries with moderate financial repression the gains would be more modest.

These relationships would also lead one to expect large gains in countries that are very poor when reforms begin, since many of these countries are much less productive than they could be if they had good policies and institutions. The very fast growth achieved by countries such as China, India, and Vietnam is consistent with the view that reform can have enormous effects on the level of output, which in turn lead to rapid growth in the course of transition to the new higher levels of equilibrium output.

That said, the claims that policy reforms would raise growth rates permanently, or by as much as 1 or 2 percentage points a year, were almost certainly exaggerated. The disappointment with the returns to policy reform stems partly from the fact that regressions have suggested that some policy variables, such as budget deficits, outward orientation, and privatization, are associated with economic growth. If such an empirical association represents a stable, uniform, causal relationship between the policy variable and growth, it is puzzling if, at least on average, the relationship does not hold for policy reforms. However, the magnitudes of the impact of the policy variables on immediate growth rates were never very clear.

To sum up, the gains from more effectively and efficiently provided infrastructure services will not be infinite but they are important, as are the gains from better allocation of financial resources.[4] Finally, not everything that is called "market-friendly" reform will work to increase output. The details do matter and it is perfectly possible to make large and costly mistakes, as attested by some of the examples in this volume.

Lesson 2

Institutional limits are needed on the exercise of discretion in policy implementation. Government discretion cannot be squeezed out of policy making, and the presence of government discretion implies the need for a solid institutional foundation to control it. Creating effective institutions that will play this role depends not just on technocratic design, but also on an underlying "shared mental model" (North 1990).

Definitions

For purposes of this discussion we define "policy," "organization," and "institutions" to mean very specific things.

A policy is a mapping from states of the world to actions. That is, a policy is not a single action but the description of a process that produces a sequence of policy actions. The policy actions may be contingent on facts: for example if a country has a fiscal policy of running a cyclically adjusted surplus of 1 percent of GDP, this requires a budget (policy action) that is tailored to the state of the business cycle (fact).

To implement a policy, translating it into practice, requires an organization of policy making.

The direct organization of policy making includes the following:

- The organization that has authority to take policy action;
- The range of feasible policy actions;
- The process to be followed in taking policy actions;
- The objectives of the policy;
- A model that determines the relevant facts (or states of the world); and
- Some indication of the policy mapping from facts to actions, given the objectives and the model. These policy mappings can take one of three archetypical forms: objectives with discretion, conditional rules, and unconditional rules.

The background institutions of policy making are the legal and political environment into which the direct institutions are embedded. The background institutions include not just governmental organization of checks and balances on the discretion of organizations and on the government itself—but also rules such as the freedom of the press and the ability of citizens to organize.

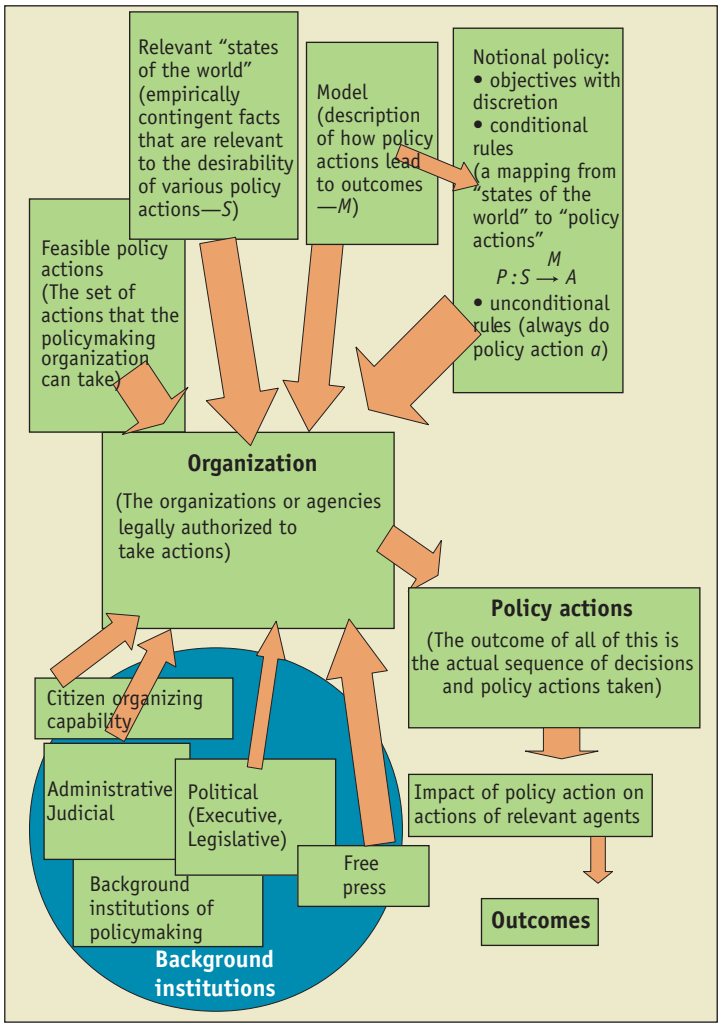
Figure 8.2 illustrates these basics. The organization responsible for implementation is the agent, to which the principal delegates the power to take policy actions. If for simplicity we imagine the organization as a single agent,[5] we can imagine a positive model of policy actions. One such model is that the organization will take policy actions that maximize its *own* objective function subject to the constraints and incentives it faces. In this sense the notional policy (proposed objectives, model, relevant facts, and proposed mapping) and the background institutions are what establish the incentives and constraints on the maximization problem of the agency.

Table 8.1 gives examples of how these descriptive terms fit into a specific area, such as monetary policy, as a component of macroeconomic policy. Each of the policy areas discussed in the previous chapters, from trade to financial sector regulation, can be understood using this same vocabulary.

Diagnosis before the 1990s: Government Discretion Is the Problem

Up to the 1990s, a prominent diagnosis of development experience had two components. First, policy mappings were seen to consist mainly of multiple objectives with discretion. Hence in macroeconomic, trade, financial, infrastructure, and regulatory policy the organizations with direct responsibility

FIGURE 8.2
The Elements of Policy Action



for policy actions were often given multiple (unclear) objectives, while at the same time they were given control over a wide range of policy actions. Second, while discretion was seen to be used well in some times and places, it was also seen to be misused, in a variety of ways (table 8.2):

- Inadequate information led to wrong decisions.
- Technical capacity was insufficient to take correct decisions.
- Multiple objectives led to ineffective actions.
- Policy actions were politicized in a way that sacrificed effectiveness for political expediency.
- Public officials had inadequate incentives to be dynamic or to innovate.
- Corruption was rampant.

Conventional Wisdom in the 1990s: Create Market-Friendly Conditions by Reducing or Eliminating Government Discretion

Given that the diagnosis was "too much discretion," the conventional-wisdom goal of the 1990s was to reduce public sector discretion as much and as fast as possible. Reformers pursued this goal in three ways (table 8.3):

- First, reducing the scope of government activities that required discretion, by removing the government from direction over production (by divesting the public sector of productive assets), and by eliminating unnecessary regulations.
- Second, in whatever regulatory or policy activity remained under the government, reducing government discretion, by pursuing rules-based formulas for decision making based on clear "objective" criteria and by granting autonomy to regulatory agencies.
- Third, making binding international commitments that limited the scope of domestic discretionary action, for example multilateral or regional international trade agreements, and agreements limiting exchange rate flexibility.

Lesson of the 1990s: Proper Exercise of Discretion in Policy Implementation Is Key

The attempts to reduce government discretion had two phases: a rationalization phase followed by an optimization phase.

The rationalization phase, which happened mainly in the 1980s, was needed and beneficial. It eliminated accretions of actions, regulations, and decisions that had often resulted in policies that served nobody's best interests.[6] Examples included

TABLE 8.1

Sectoral Example of Direct and Background Institutions of Policymaking

Item	*Definition*	*Examples from monetary policy*			
		Objectives with discretion	*Conditional rule—inflation targeting*	*Unconditional rule*	*Unconditional rule—no discretion (free banking)*
Feasible policy action	A legally authorized act by a public sector authority	Money supply	Money supply	Money supply	None
"Model"	Specification of causal chain from policy action to outcome	Money lowers interest rates, stimulates output			
Relevant state of the world	Relevant facts for the application of policy	State of the business cycle	Prices	None	None
Policy mapping	A model-informed mapping from states of the world to policy actions	Increase money when output temporarily low		Always increase money supply by *k* percent	Match outstanding obligations to foreign assets
Direct organization of policymaking	Public sector organization authorized to act	Central bank	Central bank	Central bank	Currency board
Indirect institutions of policymaking	Formal and informal checks on policy-making decisions	Procedures for administrative appeal Courts Executive Legislature Media Interest groups			

Source: Author's elaboration.

reducing the variability and capriciousness of tariff rates, closing down and consolidating many special-purpose and money-losing financial intermediaries, and selling off assets in competitive industries.

By the 1990s, reforms were moving into the optimization phase. These "second generation" reforms (Naim 1995, 1999) constituted a move to conditional rules governing the actions of a wide range of policy makers—monetary authorities, regulators of banks and utilities, and private contractors providing public services. In essence, many of the reforms were shaped by the view that institutions should play the role of eliminating discretion wherever possible, rather than facilitating effective decision making. The reforms had to grapple with the question of how core government responsibilities were to be carried out. In a number of sectors there is a core of public responsibility that governments cannot avoid. For example, while there is no compelling reason for government to own and operate commercial or investment banks, government does have a core, unavoidable responsibility and interest in the soundness of the banking sector. And while there is no compelling reason why government should run an electricity company, government does have a core, unavoidable responsibility and interest in the soundness of the electricity grid.

The attempts to reduce government discretion by imposing rules-based policies had much less impact than was hoped. In retrospect, there were two reasons why.

First, the risk that the public sector will abuse its discretion is a necessary consequence of the monopoly nature of state power over the means of coercion. If performance is poor because the public

TABLE 8.2

Examples of Misuse of Discretion

Policy area	*Motivation for public sector engagement*	*Examples of ways in which policymaking discretionary power was misused*	*Negative consequences of discretion*
Macro	Control of the money supply		
	Maintenance of system of external payments (exchange rate)	Central banks forced to "print money" to finance deficits through high seigniorage Overvalued exchange rates maintained with preferential access to foreign exchange for government and parastatals	Money creation, high and variable inflation Lack of fiscal discipline led to high debts Mismatch of monetary and exchange rate policy led to overvaluation with periodic crises and "maxi" devaluations
Trade	Revenue mobilization, industrial promotion, control of trade balance	Firms lobbied to obtain protection for politicians "pet" projects Bribery in customs to evade trade restrictions	Industries, once protected, never grew up from "infant" status Discretionary controls over imports led to "rent seeking" in the creation and allocation of import restrictions
Privatization and regulation	Supply of infrastructure	Governments used firms for patronage (for example, placement of executives) Placement of facilities was politically motivated Outright corruption in the placement of contracts	Underpricing and lack of autonomous control over adequate cash flow led to underinvestment in maintenance Multiple and unclear objectives (no "bottom line") led to productive inefficiencies and technological stagnation
Financial sector	Private sector capital markets could not provide long-term credit	Allocation of credit to politically preferred activities Rollover of debt for favored borrowers (for instance, parastatals) Selective enforcement of repayment obligations	Large losses for banks Low deposit rates (often negative in real terms) High borrowing rates for nonpreferred borrowers Capital did not flow to new, promising industries

Source: Author's elaboration.

TABLE 8.3

Efforts to Limit the Discretion of the Government[or: Government Discretion]

	Reduce the scope of government activity	*"Rules not discretion" with "independent" regulation*	*Binding international agreements*
Macroeconomic		Dollarization, currency boards, inflation targeting, independent central banks	Monetary unions
Trade	Elimination of barriers to trade	Moving to uniform tariffs; eliminating nontariff barriers in favor of tariffs	Bilateral (NAFTA), regional (EU, Mercosur), multilateral (WTO)
Privatization/ regulation	Privatization	Using contracts as a means of engaging with private sector providers	
Financial sector liberalization	Privatization of state-owned banks; elimination of regulations	Adopting supervisory standards (for example, Basel).	Allowing entry of foreign banks

Source: Author's elaboration.

[Define table acronyms here in a note if you wish.]

sector has incentives to abuse discretion (whether by failing to respond to problems, making mistakes, capricious enforcement and corruption, or outright predation), it is unlikely to be sharply improved by reforms that limit the scope of government. Policy conditionality cannot be effective except in those rare cases in which the policy action is unequivocal and compliance is easily observed. Easterly (2000) provides an insightful analysis of attempts to limit fiscal deficits through the application of rules. Suppose, as is not unusual, that a government wants to overspend—specifically, to bring expenses into the present and to push the generation of revenues into the future, hence reducing net public assets. Then suppose some outside agency wants the country to limit its fiscal deficit to a level lower than the government wants. Will a "policy" change that limits the fiscal deficit to some specified amount staunch the reduction in net assets? No. The government can reduce net public assets in hundreds of ways that do not increase the recorded fiscal deficit.[7] This ability exposes the mirage of so-called rules-based policies, because by the time one has a means to prevent all the tricks by which a simple rule such as "no fiscal deficits" can be subverted, one actually has the institutional conditions in place for good expenditure management.

The second reason why attempts to reduce government discretion by imposing rules-based policies had less impact than hoped for is that the difference between "rules" and "discretion" proved much murkier than supposed. The first round of the rules-versus-discretion debate generally ignored the key difference between conditional and unconditional rules.

The 1990s brought home that if incentives remain unchanged, and there are no background institutions to check the findings of fact, the use of conditional rules can produce exactly the same policy actions as the use of discretion. Conceptually, and often in practice, the process of policy actions with conditional rules can be divided into two stages: a findings-of-fact stage and a policy action stage; as noted above, the findings of fact dictate the policy action (or narrow range of actions). The scope for exercising discretion can then be pushed back from the policy action stage to the findings-of-fact stage.

A telling example comes from Indonesia's attempt to create bankruptcy courts. In the wake of the financial crisis, many observers felt that the lack of a credible judiciary was limiting creditors' ability to enforce their contracts or even to force debtors to negotiate resettlements. Because judicial reform is a slow process, a new bankruptcy law was passed that attempted to remove all discretion from the courts in bankruptcy cases. The only role left to the courts was to declare a debtor bankrupt,[8] and after the judicial declaration of bankruptcy all future jurisdiction passed to the group of creditors. The result was that in the first few high-profile bankruptcy cases the judges did not declare bankruptcy because they found that a "legal" debt did not exist. Instead they used various criteria to show that otherwise apparently ironclad debt contracts did not in fact constitute debt. The new law had not changed anyone's incentives. There were no credible checks on the courts' findings and hence the exact same result—lack of a credible creditor threat of bankruptcy—was reached even in the face of determined attempts to remove discretion from the legal process.

This conceptual framing may help us to understand several elements of the experience of the 1990s:

- Why the success of reforms differed so widely across countries, and the significance of new evidence about the importance of institutions over policies;
- The evolution of concerns from policy reform to governance and institutions;
- The mixed popularity of growth reforms and importance of perceptions in the success of reform; and
- The evolution toward policy recommendations designed to fit specific institutional capabilities, as opposed to the application of universal best practices.

We discuss each of these elements in turn.

Intercountry differences in the success of reform. Why did the success of reforms differ so widely across countries? The answer may lie in the combination of a country's initial level of income and its institutional capability to implement complex reforms.

Many of the biggest successes of the 1990s were achieved by countries that were much less productive than they could be with good policies and institutions, so that modest reforms whose implementation was not institutionally demanding were able to produce large gains in expected future income. Examples are China's liberalization of agriculture and India's dismantling of very high trade barriers.[9]

The varied experience of the transition countries illustrates the difficulty of achieving the right mix between declared policies and institutional capability. A viable financial sector that channels resources to productive investments is key to a market economy. Reform efforts in this direction sometimes had acceptable results—for instance in Hungary. In Albania, by contrast, financial sector liberalization with essentially no government control led to a giant Ponzi scheme,[10] and after a brief bubble, to massive losses that forced the government out of power. In some countries of Eastern Europe, privatization worked reasonably well. In others, privatization was achieved rapidly but it was followed by a shake-out, because the institutional capability for regulating the basics of corporate governance did not exist. Another group of East European countries pursued a so-called policy of privatization without any credible central authority, any mechanisms of public sector accountability or corporate governance, or any means of legal enforcement of contracts. This concentrated assets in the hands of those who were able to operate in such an environment.

Latin America's experience was mixed. By and large, the countries of the region began with a base of better policies and more advanced institutions, offering less "low hanging fruit" for reformers than in Asian and transition countries. Most Latin American countries had to grapple with institutionally intensive reforms—financial sector regulation, and regulation of privatized infrastructure—in the 1990s. Not surprisingly, therefore, some reforms worked well and were widely popular, some worked well and were unpopular (such as the privatization of water utilities in Argentina), and some worked badly with recriminations all around (for example the first round of Mexican toll roads).

Evolution of concerns from policy reform to governance and institutions. Current discussions about the investment climate differ from 1991 discussions of "market-friendly" policies. The recognition today is that, except for a very few macroeconomic policies that can be executed with the stroke of a pen and easily observed, policies are meaningless unless they are backed by controls that make the policy actors sufficiently accountable.

Take the example of replacing the public provision of an infrastructure service with private provision by a contractor. The public agency responsible for awarding the contract must announce the winning bidder. Most of the second generation reforms in infrastructure dealt with extremely complex services, for which the evaluation of bids inevitably involves some discretion (one does not merely want to choose the lowest bidder without prequalification, consideration of the full range of services included in the contract, and so forth). But the necessary discretion that is created by complexity can lead to inefficiency, malfeasance, or corruption. The same is true with the transition from concern with fiscal discipline to a broader concern with budgetary institutions. While it is easy to place conditions (either via rules or outside agencies) that govern easily observable policy variables such as the fiscal deficit, it is impossible to mandate that public monies be well spent. Similarly, sensible regulation of banks requires the use of considerable judgment. Because of the importance of trust between borrowers and lenders, especially in environments in which the formal mechanisms of contract enforcement are weak, close continuing relationships between banks and firms tend to be the norm. From a regulator's perspective this makes it difficult to distinguish between a perfectly rational business

decision to carry a long-term customer over a difficult spot by rolling over loans and a bank's unwillingness to realize and write off bad debts. The regulator's problem in observing the "true" facts about any given loan is of course compounded when a regulatory agency is held accountable for thousands of such decisions made every day.

The mixed popularity of growth reforms and importance of perceptions. Analyzing the institutional conditions for policy implementation may also help to explain why many market-oriented reforms—even those for which there is evidence of success—have not been altogether popular. In Latin America, for example, bringing more market forces into the provision of infrastructure has improved the quality of services and expanded their coverage, but prices have risen and "privatization" is widely unpopular. A possible explanation is that a lack of public confidence in the regulatory institutions means that the public may perceive deals as fixed or corrupt and price increases as simply leading to high and unjustified profits for firms, which have regulators "in their pockets." This is a hard problem to deal with.

The evolution toward policy recommendations designed to fit institutional capability. Suppose that some goods have dynamic externalities, so that greater domestic production of these goods raises a country's overall output, and that other goods do not, so that their protection and greater domestic production cause overall output to be lower.[11] Assuming that tariff rates can change relative prices, a possible tariff policy would be to place a high tariff on the good with dynamic externalities and no tariff on the growth-reducing good. This policy is a conditional rule that depends on distinguishing which good is which. In practice, however, this distinction might be difficult to draw and to verify. Now suppose that producers of the growth-reducing good offer a larger bribe than producers of the growth-enhancing good.

In such a situation the optimal policy depends entirely on the institutions of policy making. If we define good tariff policy institutions as those providing institutional conditions in which the conditional rule, "high tariffs on growth-promoting goods," will be applied correctly, with good institutions the best policy to choose is a conditional rule. But the institutions of tariff policy could be weak. They might lack the technical capacity necessary to assess which goods are growth-promoting and which are not. Or, if they were faced with discretion or a conditional rule, their findings of fact might be susceptible to political influence or outright bribery. If the direct and indirect institutions of policy making are weak, the optimal policy is an unconditional rule of uniform tariffs, and perhaps even zero tariffs (table 8.4).

More generally, if it is perceived that corruption is the central problem in public sector action, the tendency will be to force all discretion out of policy implementation—for example by removing the government from bank regulation. Good regulation is better than no regulation. But no regulation is better than bad regulation, and where mechanisms are not available to control the discretion that is inherent in attempts to implement reasonable policies, "no regulation" may be the appropriate choice.

TABLE 8.4

Example of the Dependence of Appropriate Policy on Institutional Conditions

	"Bad" institutions	*"Good" institutions*
Differentiated tariffs (either discretion or "conditional rules")	Can lead to lobbying, rent seeking, corruption, and mistakes and result in complex, distorting tariffs with no positive effects	Can allow trade policy instruments to promote nascent industries with possible dynamic externalities
Uniform tariffs	Forgoes possible benefits of differentiation, but avoids losses from rent seeking	
Better policy	Uniform/precommitment	Differentiation

Source: Author's elaboration.

Similarly, if the central problem is that private investors fear predation by the state, strong preconditions to prevent predation are needed—even if their introduction sacrifices otherwise desirable regulations or actions.

The debate today is no longer about whether "the market" or "the state" is always superior, nor is it about "the proper role of the state" in the abstract.[12] As theorists, most prominently Joseph Stiglitz, have shown, one can always create a theoretical model in which state action can improve on the free market outcome—if the state action is perfect. But, as Pigou pointed out nearly a century ago, the real choices are not between the best the economist can imagine and "the market." The choice is between the market such as it is and what will actually happen if a given policy is adopted—which in turn depends on the actual policy decisions that will be taken, which in turn depend on the quality of institutions for controlling the discretion used in policy implementation.[13]

This discussion points forward to the problems addressed in chapters 9 and 10. If the key problem is policy implementation, and the key problem with implementation is to create the conditions for the effective exercise of government discretion, the organizations of the public sector are vitally important (chapter 9) and so are the background institutions of policy making, especially the ways in which citizens are able to monitor the performance of government (chapter 10).

Lesson 3

Expectations play a crucial role in the success of policy reform. And political and social legitimacy and continuity are important in promoting expectations of a more stable investment climate.

If the gains from policy reform are to be realized, individuals and firms must believe that if they invest in response to the opportunities created by the policy reforms, they will reap the gains of their investment. Investment is always about the future, and about the future there are no certainties, only beliefs and expectations.

Diagnosis before the 1990s: Policies Had Put Too Much Faith in Government as the Driver of Growth

As detailed above, the key explanation for the slowdown in growth in the late 1970s and early 1980s was that policy makers had simply been wrong in their attempt to extend the scope of government action beyond the government's implementation capacity.

Conventional Wisdom in the 1990s: Fixing Policies Would Ignite Growth

The conventional wisdom of the 1990s was that fixing policies would ignite growth. The belief was threefold:

- Get the policies right and investors will respond.
- Bold action upfront signals the seriousness of reform.
- Signaling to the market requires ambitious reform agendas.

Lesson of the 1990s: Expectations Are Central

Not only does the investment climate need to improve, but also investors (small and large, domestic and foreign) need to believe that the improvement in investment climate is here to stay. The 1990s emphasized that expectations are central not only as regards stabilization during crises, but also as regards the supply response to policy reform. We discuss these two aspects in turn.

Crisis management. Restoring expectations is often the single most important factor in turning around a crisis.

> To restore credibility [after a crisis] you have to show that your word is your bond… [I]t is crucial to choose targets that can be and are met. This is more important than issuing unrealistic projections...
>
> —Kemal Derviş in World Bank (2005b)

> Our strategy at the Central Bank was based on the view that, given the lack of reference

> for the correct exchange rate, exchange rate expectations had to be stabilized for the bank to develop a market for its sterilization instruments. Otherwise, the interest rate needed to induce significant demand for the new instruments would reach unreasonable levels. In other words, an interest rate defense and active foreign exchange market intervention were complementary rather than substitute policies. These three policies were popularly characterized as a Central Bank attempt to increase demand for domestic assets—and in this way stop the bank run and the currency run—by inducing greed to overcome panic. The bank's main consideration was that greed (interest rate policy) cannot overcome panic unless panic is also reduced by controlling chaotic conditions in the foreign exchange market through active intervention.
>
> —Mario Blejer, in World Bank (2005b)

There is disagreement on two big issues. The first is that of the proper scope of a reform program in the midst of the stabilization of a financial crisis. One view is that the reform should be limited and feasible, because an overambitious reform can backfire by creating expectations that cannot be met. The other is that the reform should be big, broad, and aggressive, because that convinces the markets that the government is serious about reform. But if in fact the big broad and aggressive measures are ad hoc and not institutionalized, there is a risk that meeting the targets will not create confidence, while missing them will create damage. This is particularly true of implementation-intensive reforms incorporated into crisis stabilization packages.

The second big issue is whether expectations can be positively affected by tying a government's hands. For example, in the early 1990s there was a view that countries should move to either fixed or completely flexible exchange rates to show evidence of the complete removal of government discretion. But since the Argentina crisis, some observers believe that removing discretion by creating mechanisms that impose large penalties may itself undermine expectations. Velasco and Neut (2003) argues that if the world is uncertain and there are situations in which the lack of discretion will cause large losses, a precommitment device can actually make things worse.

Achieving a supply response. The supply response to any given policy action depends on how credibly that policy action signals a sustained rise in the level of income. Many of the benefits of trade liberalization, privatization and/or deregulation, and financial sector reform depend on the responses of private investors. The gains come with new export industries, new expansions of industry, improvements in efficiency and productivity (which often require investments), and new activities. Small reforms may have big impacts if they are seen as harbingers of future reforms, while large reforms may have little impact if investors perceive the results as temporary.[14] Though the supply response to a policy reform is limited by credibility, larger supply responses make for greater support for continuing the policy, creating a virtuous circle in which successful reform leads to continued reform.

Many problems may interpose themselves between policy reform and the faster growth it is designed to achieve (table 8.5).

The first possibility, which has received a great deal of attention, is that policy actions may or may not signal policy reform. For example, if the budget deficit is cut from 5 percent to 2 percent, does this signal macro-stability or merely reluctant compliance with external pressures? Certainly expectations about future macroeconomic stability will differ dramatically depending on which of the two is perceived to be the case. Conventional wisdom holds that part of the reason why policy conditionality had a disappointing impact on growth was that the conditioned changes in policy actions did not change investors' expectations about the long run. As a result, the 1990s saw a growing emphasis on the ownership of reforms as key to a successful investment and supply response. Without ownership, current policy actions may not signal future policy actions and hence do not create a powerful investment response.

TABLE 8.5

Policy Reform and Growth: Sources of Differential Impacts

Question	*Effect*	*Possible slips between policy action and growth/output response*
By how much does a policy action raise growth?	$\partial \dot{y}_t^j / \partial \text{Policy action}_t$	
Does policy action change anticipated *policy?*	$\partial AP_{t,T} / \partial \text{Policy action}_t$	• Policy action conditioned • Policy action unsustainable (either economically or politically) • Policy actions not institutionalized
Do changes in trajectory of policy change the trajectory of distributions of profitability?	$\partial R_{t,T} / \partial AP_{t,T}$	• Changes in returns not large • Policy is "wrong"
Do changes in trajectory of profitability raise desired capital stocks?	$\partial k_{t,T}^{j*} / \partial R_{t,T}$	• Expected profitability higher but uncertainty higher (and investors not risk neutral) • Policy changes *lower* profitability in the short run (adjustment costs) but raise it in the long ru • Complementarities
Do changes in desired capital stock(s) lead to investment responses?	$\partial \dot{k}_t^j / \partial k_{t,T}^{j*}$	• Financial system does not accommodate • Other aspects of investment climate unfavorable to investment

Source: Pritchett 2003a.

Even if a policy shift is owned by the current government, the shift may not change expectations if it appears likely to be reversed by either the current or a future government. And even if investors believe that current policy actions signal a true shift in policy, and even if they do not expect the policy to be reversed, the fact that new policies often call for new organizations and direct institutions of policy making implies that investor confidence may be difficult to build.

This can create a particularly difficult dynamic, particularly in the interaction between government and providers of infrastructure. This dynamic is that—even if investors would invest at existing profits/prices if they were confident these prices would persist—they fear the government may renege on its commitment to price regulations and attempt to squeeze their profits in the future. If that is so, investors will be willing to invest only at a large risk premium over and above profitability. But—particularly in a weak political and institutional climate—the likelihood that a government will renege is higher, the higher the ex post profitability. The risk of reversal alone can block an investment response, given that the only profit rate at which investors would be willing to risk their capital in new investments is one at which governments cannot resist public pressure to lower prices. Hence the risk of policy reversal can itself create a self-fulfilling prophecy of failure.

These dilemmas explain the continuing search for mechanisms with which to signal a government's commitment to the irreversibility of reforms. The temptation has been to argue that the lack of a supply response meant that reforms had to be pushed harder, faster, and deeper. But this is not necessarily so. If the problem is that the reforms are not expected to be sustained because they are too aggressive, pushing them harder might further undermine expectations of their sustainability. To sum up, acknowledging the importance of expectations does not imply that either big bang or gradualism is the right approach to policy reform, but it is a reminder that excessively ambitious reforms that are delayed in implementation can hinder the formation of positive expectations.

2. The Way Forward

Taking on board the lessons of the 1990s, what is the way forward? Three guidelines are discussed in what follows:

- Accept that there are many ways to implement common principles.
- Pursue growth strategies—not just stabilization or the avoidance of problems.
- Create the institutional conditions for a favorable investment climate.

Common Principles—And Many Ways to Implement Them

Perhaps the most important and difficult lesson of the 1990s is that there is no one right way to achieve development.

The 1990s have not proved mainstream economists wrong; indeed the basic principles of economics have proved remarkably resilient. In countries such as Poland, the Czech Republic, and the Slovak Republic where the introduction of incentives proved feasible, they have worked remarkably well. In China and Vietnam, the introduction of stronger incentives has led to the most rapid poverty reductions in history.

What was wrong, and never should have been part of economics, was the belief that the first principles of economics had to be implemented in a particular way (Rodrik 2002). This point can be illustrated with regard to four economic principles:

- *Expectations about future claims.* Investors need certainty that they will reap the gains of their investment. But this stability of expectations can be sought in a variety of ways. For example, do favorable investor expectations depend on property rights? Do property rights rest on the same definition of property and the same means of enforcing those rights as have developed in some particular industrial country? Experience with land titling has shown that, in some cases, holding the title to land increases a farmer's incentives, but in other cases the existing informal systems have provided adequate security. One way of providing property rights is through a well-functioning legal system, but many countries achieved decades of rapid growth with very little legal certainty, when stability was embodied in the political system.
- *Openness.* The principle of openness to ideas, trade, and investments with the rest of the world need not entail free trade. There are many ways of engaging productively in international markets. Even the four East Asian Tigers, all famed for being outward oriented, differed widely in the extent to which their governments intervened in the economy and in international trade. While Hong Kong (China), as a trading center, was always open, the Republic of Korea opened its markets to imports only quite late in its growth process. While some economies invited foreign investors, Korea had very little direct foreign investment.
- *Competition.* The principle that competition from alternative suppliers promotes productive efficiency does not dictate that competition has to take any particular form. China's experience with township and village enterprises, which were not private enterprises in the usual sense but created effective competition, is instructive (see box 6.1 in chapter 6).
- *Macroeconomic stability.* The view that this or that particular arrangement is needed in order to create macroeconomic stability is belied by the diversity of experience of countries that tried the same thing, and the similarity of experience of countries that tried different things.

To conclude this discussion of the different modalities for implementing common principles, it should be emphasized that "one size does not fit all" should not be interpreted as "anything goes." A vast array of policies in the world are not fundamentally sound, and are not heterodox implementations of sound orthodox principles. A vast array

restrict competition in order to protect existing owners (private and public), and create investor uncertainty through arbitrary and capricious behavior by state officials. What is needed is not less economics but more and better economics, to identify the exact set of policies and institutional changes needed to address binding constraints on growth, based on first principles in each instance.

Growth Strategies

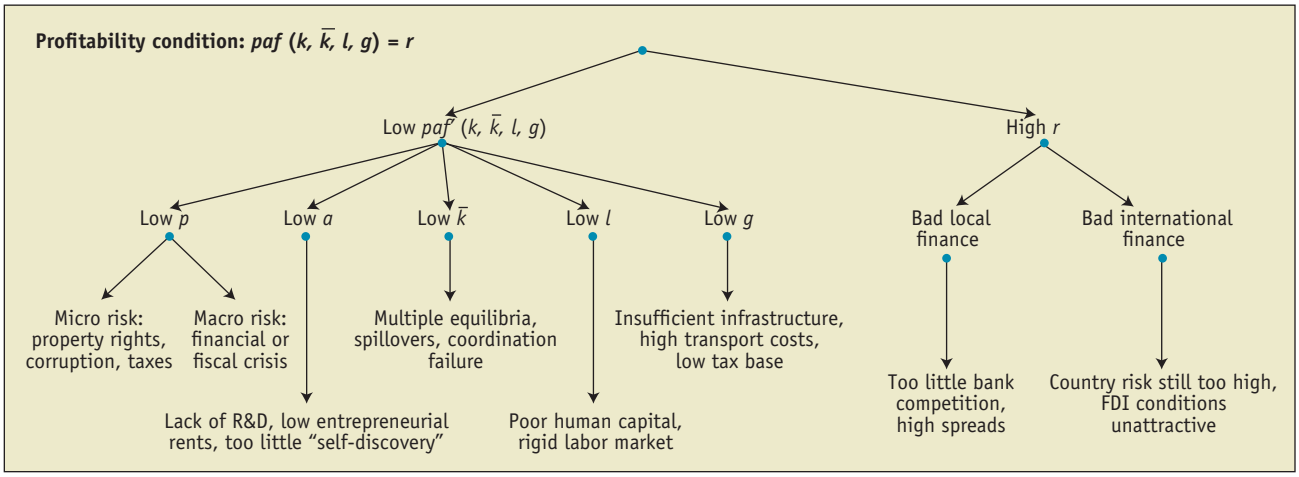
If policy reform, while beneficial, does not explain the bulk of the variation in growth performance across countries and time, something else must. As discussed in chapter 2, recent research has emphasized that there are large numbers of extended episodes of rapid growth—some sustained and some not. How these growth episodes are initiated and sustained is a key question. While "policies," as represented by standard growth-regression measures, do increase the likelihood of a growth episode, they are far from sufficient to explain growth. And what causes the start of a sustained episode of rapid growth is not well understood.

In any developing country, nearly everything is far from ideal. The 1990s have shown that to achieve rapid growth, countries do not need to get everything right but they do need to get the *right* things right. Identifying those right things is the purpose of devising a growth strategy, which is a coherent set of actions designed to initiate and sustain rapid growth.

Devising a growth strategy requires a clear diagnosis of the obstacles to growth—in particular, the binding constraints, which will vary widely depending on countries' initial conditions. To illustrate, figure 8.3 from Hausmann, Rodrik, and Velasco (2004) maps the possible explanations of slow growth in a country in which the slow growth is associated with low rates of investment and entrepreneurship.[15] The figure emphasizes that starting from fundamental principles can lead one's search for binding constraints in many directions. For example, starting from the condition that profitability must exceed the cost of investment, perhaps the cost of capital is too high; perhaps investors fear macroeconomic instability; perhaps too few profitable opportunities are discovered; or perhaps infrastructure deficits raise costs.

FIGURE 8.3

Diagnosing the Problem of Low Levels of Investment and Entrepreneurship



Source: Hausmann, Rodrik, and Velasco 2004.

Note: FDI stands for foreign direct investment; R&D stands for research and development.

One problem, particularly with strategies that involve donors, is that governments face pressure to act on all fronts simultaneously. In creating an all-encompassing document such as a poverty reduction strategy paper it is very easy to justify anything as being important to growth—from low human capital, poor health conditions, judicial insecurity, weak infrastructure, a weak civil service, to stagnant investments in agriculture. Thus too often a proposed strategy becomes a menu, not a meal. To be sure, all of these problems will at some stage need to be addressed. But identifying the binding constraints on growth and focusing on them is the essence of strategy.

Institutional Conditions for a Favorable Investment Climate

For investors, the launch of any new public policy initiative raises the question, How will policy actions evolve with this new policy? For governments and societies at large, a key question going forward is, How does one develop the institutions of policy that reliably lead to the (mostly) positive use of discretion in policy implementation?[16]

First, continuity in the background institutions of policy making is conducive to success in pursuing individual reforms. One of the problems with the transition in Eastern Europe and former Soviet Union countries is that investment depends on expectations of policy implementation, that policy implementation depends on background institutions, and that when institutions are in flux no one can say with certainty what will happen. The fact that Indonesia has had much more difficulty than Korea and Thailand in restoring growth after crisis is almost certainly because Indonesia's background institutions have shifted, so that no one can predict quite where they will lead, while those of Korea and Thailand have not. Often shifts in background institutions are seismic political events beyond the control of any policy maker. But experience does suggest that new governments that are in the midst of an institutional shift should consider it a priority to establish credibility around a few key areas, rather than undertaking a broad array of new policy initiatives whose success may depend on expectations.

Second, if the key problem is that credible background institutions that can limit predation by the state, such as an independent judiciary or electoral accountability, do not exist and the government cannot make a credible commitment to resist predatory behavior, it is possible that no amount of institutional reform will sufficiently reassure investors. Acemoglu, Johnson, and Robinson (2001) have argued strongly that what is meant by "institutional quality" is not the state's ability to regulate transactions between individuals, but rather a country's ability to limit the state's temptation to expropriate. Since economic elites often benefit from controlling the state and existing institutions (Hellman, Jones, and Kaufmann 2000; Acemoglu, Johnson, and Robinson 2001), there may be little internal impetus for reform, precisely when it is needed most.

Third, the capability of the direct organization of policy making is often a key issue in debates about reform. For example, should one privatize when there is no regulator? Should banks be liberalized while prudential regulation is weak? Particularly with the large fiscal losses in the financial sector in the 1990s, should reforms have been more gradual, with greater attention paid to prudential regulation? In some cases "the use of all deliberate speed" is hard to distinguish from "never." Another school of thought argues that capacity only develops in response to need, and so if one delays the privatization of utilities until one has developed an adequate regulatory capability one might delay forever. Indeed, it is hard to build experience in regulation if there is nothing to regulate.[17]

A fourth area of debate about creating favorable expectations is the tension between attempting to reassure specific investors and improving the overall investment climate. Some would argue that since the costs of investment are so high, and improvement in organizations and institutions is so slow, the best way to attract investment in the short run is to nurture individual investors, either on a deal-by-deal basis or in special regimes (such as for foreign

investors). The latter approach, bypassing the weaknesses in the overall investment climate, is attractive because initiating a new industry or endeavor often requires attracting a large investor. Certainly this approach has been made to work, but it has dangers. Complex special deals can be conspicuously opaque and a perfect vehicle for corruption. Particularly when their negotiated terms are contested, special deals can undermine the perception of social and political legitimacy of a government's overall policy approach (the deal with Enron in the Indian state of Maharashtra and the water deal in the Bolivian city of Cochabamba are examples). Particularly in infrastructure, the renegotiation of individual deals has proven be an enormous challenge (World Bank 2004e). Finally, cutting deals for specific investors or specific classes of investors can undermine the pressures for systemic improvement for all investors. De Soto (2005, forthcoming) is eloquent on the fact that most Latin American investors exist outside the scope of the formal legal economy.

Notes

1. This feature, "Solow invariance" (Hall 1999), is robust and driven by basic features of these models.
2. The classic example (perhaps because it was there that the theory had been the most clearly worked out) was the calculation of the welfare losses that resulted from the differences between international and domestic prices induced by border restrictions on trade, such as a tariff. The standard analysis showed that a tariff raised prices, which benefited producers and hurt consumers, but that the efficiency losses from "too little" consumption caused an overall net social loss. Graphically this loss of consumer surplus was a triangle—in fact the estimates of the losses from price distortions were known as Harberger triangles (after Arnold Harberger 1971). The "partial equilibrium" estimates suggested that a move from the current level of restrictions to completely free trade would produce welfare gains on the order of 1 to 5 percent of GDP. These small estimates implied that the temporary "growth" effects caused by the transition from lower to higher levels of (properly measured) output from efficiency-improving reforms were quite limited.
3. That is, $\left.\frac{\partial \gamma^{\star}}{\partial A}\right|_{\infty}$.
4. Many proponents of the efficiency case for the welfare gains from trade (as opposed to the "growth" arguments) are strong supporters of free trade. Jagdish Bhagwati frequently points out that there was never any theoretical support for growth-regression-based claims on behalf of trade liberalization—but that theory and evidence on the microeconomic level provide all the support one needs.
5. Of course, in reality each organization will have its own "principal-agent" problems.
6. For instance, in trade policy an original policy would be set, restrictions would be added, and then exceptions granted, and then new categories created, and then other new restrictions added. Many countries had reached the point where few people actually knew what the trade regulations were (in many cases, even customs officials did not possess fully up-to-date copies of the tariff code) and where, taken as a set of interventions, the trade policy was "irrational." Similar accretions—taking over firms that had gone bankrupt here, making a firm a parastatal in order to obtain official financing there—often led to government ownership of a variety of businesses and activities for which there was no coherent rationale.
7. Suppose that to meet the fiscal deficit target the government simply lengthens payments to suppliers. This does not change net public assets. One could imagine then putting limits on both the cash fiscal deficit and the payment of suppliers. A government could then defer spending on the maintenance of public assets, causing potentially the same (or an even larger) reduction in the value of net assets while meeting the same target for the fiscal deficit plus payables. One could then set conditions that specify a cash deficit target, a limit on payables, and a limit on the reductions in maintenance. But there are still many other ways to reduce net public assets—for example freezing the nominal wages of public sector workers at lower than sustainable levels, or underfunding future pension obligations, or authorizing expenditures (such as guarantees of lending) that create a quasi-fiscal obligation.
8. The new law attempted to remove every vestige of judicial discretion by declaring that if any creditor petitioned for a bankruptcy and a debtor was more than a certain number of days overdue on a contractual payment, the judge must declare bankruptcy.
9. For instance, in the early 1990s tariffs in India were four to five times as high as in most Latin American countries.
10. A Ponzi scheme refers to any investment that pays off initial investors unsustainably large returns not out of actual returns from investment but from flows of funds from new investors. These depend on rapid growth in

new investors, but in the end not every investor can be paid the promised high returns.

11. This would be the case, for example, for a good that is an input into many other goods and is produced by a domestic monopoly.
12. No one can look at the experience of Singapore or the Republic of Korea (and earlier Japan) without being convinced that purposive government action to promote rapid development can succeed. Conversely, no one can review the tragic experience in many African countries and believe that purposive government action (at least ostensibly) to promote rapid development cannot fail.
13. Comparing industrial countries with poorer countries, it is noticeable that government action is much more pervasive in industrial countries—tax rates are higher, and regulation is pervasive—and that the exercise of discretion is explicit, and that much of the infrastructure is owned and operated by the public sector. A frequent practice has been to attempt to transplant more or less wholesale the policies of industrial countries—including the direct institutions of policy making—without adequate consideration for whether the transplants could survive in entirely different conditions. For example, every industrial country regulates banks. But can banks be successfully regulated without an effective legal system that can enforce creditor rights? Without a strong tradition of an autonomous civil service that can resist political pressures? Without effective legislative oversight? Without transparency and an aggressive free press? Without a police force that can protect impartially against threats of violence?
14. These observations are part of the same overall story as the first two common lessons in this chapter—the question of large- versus small-level effects and the importance of institutional quality for successful policy implementation.
15. If investment were high and growth slow, a different diagnostic would be appropriate.
16. This is the main question in chapter 9, which reviews efforts in the 1990s on several fronts.
17. Countries with parastatal firms had decades in which they could have created regulatory capability—but they did not do so, in part because it was not perceived as necessary. Similarly with financial sector regulation: developing the capability for "arm's length" regulation when the government embraces the entire sector is conceivable, but difficult.