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**Author**

Rausser, Gordon C.

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DEPARTMENT OF AGRICULTURAL AND RESOURCE ECONOMICS  
DIVISION OF AGRICULTURE AND NATURAL RESOURCES  
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IMPLICATIONS OF THE STRUCTURAL ADJUSTMENT EXPERIENCE IN  
THE DEVELOPING WORLD FOR EASTERN EUROPE: DISCUSSION

by

Gordon C. Rausser

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# IMPLICATIONS OF THE STRUCTURAL ADJUSTMENT EXPERIENCE IN THE DEVELOPING WORLD FOR EASTERN EUROPE: DISCUSSION\*

Gordon C. Rausser\*\*

The presentations in this session were far more interesting than the formal papers. I make this assessment in a world of limited information, as I have only just received Dr. Csaki's paper and have yet to see Dr. Braverman's paper. This condition leaves me with the freedom to pursue my own thoughts rather than evaluate two papers, one of which I can only imagine from the verbal presentation. Along the way of sketching my own thoughts, however, I will make some reference to the fine presentation of Dr. Csaki (hereafter referred to as A.C.) and the comments and observations of Dr. Braverman (hereafter referred to as B.C.).

Communism has failed. In the aftermath of last year's extraordinary events, it is clear that the ideological appeal of communist political systems has been irrevocably damaged. Throughout much of Eastern Europe and the donor community, there is a clear vision of where each country wants to "arrive"; unfortunately, there are few clues about the path that should be traveled to get from "here" to "there." A.C. informs us that the most important task is to develop a market-oriented and competitive agricultural structure. Yes, but how! To be sure, some individual policies that have formed the basis for successful market economies, if introduced with the wrong timing or in isolation from other reforms, can make an inefficient economy performance even worse.

For each of A.C.'s five major issues, he outlines a number of policy alternatives. As with A.C., B.C.'s presentation largely focuses on the policy instrument space; the right setting on producer prices; consumer prices; pricing of credit; allocation and ownership of land; and so on. It is my view that prescription in this space, the selection of policy instruments, is misguided and is most likely to lead to the wrong path in getting from "here" to "there."

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\*\*Robert Gordon Sproul Distinguished Professor, Department of Agricultural and Resource Economics, University of California at Berkeley.

Instead, our prescription should focus on the underlying constitution that establishes the guidelines and mechanisms for economic, political, and civil freedoms. It is not establishing simply the "rule of law," but also the choice of law and the extent of liberty. This includes a selection from among the legal traditions that rule mankind: civil law, common law, oriental law, hindu law, muslim law, and socialist law. In this choice, as in all constitutional economic selections, the political-economic landscape, the culture, and the customs of the country in question must be formally recognized.

### **Experience in the Developing World**

The above observations are based on the empirical evidence that has emerged in developing countries. This evidence is drawn from developing countries which differ, not only in the details of their economic policies but also in their underlying constitution institutional framework, the extent of freedom and liberty, and their whole approach to growth and development. Serious inspection of this evidence reveals that: (a) "getting the prices right" or "setting the property rights straight", or both, is not sufficient for an economy to reach its full potential; (b) bad governments and institutions have been a serious, if not the most serious, obstacle to economic development; and (c) all public sectors pursue a mix of predatory and productive activities—bad governments emphasizing the former and good governments finding a way of promoting the latter.

Available evidence reveals that, the more centralized the system of economic decision making, the more opportunities are presented to officials to behave in a predatory manner. The degree of centralization in economic decision making is one of the characteristics that distinguishes those countries that were successful in achieving desirable economic reforms from those who failed to do so during the 1980s. In Bolivia, for example, one of the least-developed and poorest countries in South America, a large informal sector existed, while state intervention and control was confined mainly to an obsolete, but limited, formal sector.

In Argentina and Brazil, sophisticated systems, computer-assisted bureaucratic administration and control were overlaid by large and pervasive systems of quasi-governmental production and resource allocation. These systems, in turn, created their own large and powerful constituencies. They also created enormous opportunities for corruption and graft. The general rule is: He who decides who gets subsidized can get very rich, especially in an economic system characterized by central administration and control.

The degree of centralization in Eastern European agricultural sectors concerns both A.C. and B.C. in terms of the ownership, operation, and distribution of land resources. Based on the experience in developing countries, some economists have identified equity of land distribution as an empirical characteristic useful in explaining economic performance across countries. Here, the Latin American economies and the Philippines—where land ownership is highly centralized in patterns inherited largely intact from colonial periods—may be contrasted with the model economies of East Asia, such as Taiwan and Korea, or even Japan. In Korea and Japan, land redistribution was instituted by the allied powers following World War II. Land ownership in Taiwan began to change when the Nationalists took over the island in the 1930s. But land distribution, itself, is hardly an explanation for the far superior, post-war economic performance of the East Asian economies.

Instead, the most intriguing aspect of land distribution is what is implied about the political influence of the land-owning, agricultural factions in each country. An alternative hypothesis is that, although land redistribution partially rearranged the old political-economic alignments in Korea and Japan, this was not sufficient to allow new export-oriented policies (e.g., competitive exchange rates and low tariffs) to be implemented without significant opposition from the domestic agricultural factions. In Taiwan, too, the post-war agricultural sector was closely aligned with the Nationalists and was clearly a faction to be reckoned with. Each of those countries instituted economic policies to compensate agricultural interests (via high-tariff and non-tariff barriers) in return for the freedom to proceed with

export-oriented policies in the balance of the economy. This policy mix has proved to be remarkably stable and survives largely intact to this day in each of those countries.

Although traditional or in-power factions may have a stake in opposing change, often there are no viable alternative factions capable of its advocacy within the political system. Hernando de Soto, from Peru, details the enormous political and institutional hurdles that must be overcome by individuals and businesses when they are not a part of the dominant political-economic faction. His prescription is to mobilize alternative factions so that they can represent their own interests. However, this may not be feasible without political and institutional reforms to remove the barriers to such advocacy. Even in a democracy, alternative constituencies must be enlightened as to what various policy options would imply for them if they are to be effective. They must also be given the means to voice their concerns and interests within the constitutional process. And there must be checks and balances that limit the ability of any single faction to gain and retain unchallenged political and economic control.

Available evidence suggests that, when domestic constituencies have emerged that favor and benefit from new policies, reforms have been sustained and credible. Occasionally, special inducements, e.g., export subsidies and export-processing zones, have succeeded in creating those new constituencies. Often the objective is not to achieve a trade-neutral regime but, instead, to bias the system in favor of exports, at least temporarily, in what might rightfully be called redistributive governmental policymaking. This policy, in isolation, however, has not generally been successful. Once again, it is crucial that comprehensive economic reforms be designed covering the mix of policies across all sectors as well as fiscal, monetary, and exchange-rate policies. When accompanied by appropriate exchange-rate and macroeconomic policies, special inducements can assist in sustaining export-oriented policies in the initial stages introducing structural reform. Successful examples of this tactic in the 1980s include the Dominican Republic and Costa Rica

It must be acknowledged that the best examples of successful economic developments in the 1980s were not nascent democracies but, rather, holdover authoritarian regimes: Chile, Thailand, and Korea are the most often cited; examples from earlier decades might include Hong Kong, Taiwan, or Singapore. Yet, the overwhelming weight of empirical evidence in modern times suggests that the most open and democratic societies are the most successful economically and that free and decentralized markets are the most successful in producing sustained economic growth, a condition conducive to political liberty. Sustaining economic success in the long run, in fact, may require democracy. Certainly, there are no examples of modern industrial countries that have continued to achieve success in economic growth and development under authoritarian or totalitarian governments. Even in the short run, the civil, legal, and political institutions of democracy, in many cases, seem to be an important ingredient of success in the economic sphere.

The problem is that democratic systems sometimes produce extremely disappointing economic policies—hence the lure of authoritarianism. Likewise, there sometimes are significant instances of market failure that can be improved through nonmarket organizational structures, including governmental intervention and regulation (A.C.'s reference to environmental protection). Depending on what one believes to be market failure, this reasoning, if taken to extremes, can imply central planning and economic control. Moreover, in many developing countries, as was the case recently in Poland, the pain of adjustment in attempts to move from "here" to "there" is often blamed on the new policies rather than on the failed policies of the past. If the distribution of political power leads to an unwinding of currently designed reforms, market expectations of failure will induce inflation, capital flight, hoarding, and so on. This has often led to reversals of experiments with decentralized economic decision-making reforms.

The irony is that dictatorship, far from being necessary for economic growth, may be its antithesis because corrupt and inept regimes and economic policies cannot be changed by the will of the citizenry. There is no better confirmation of this statement than the post-war

experience of Eastern Europe under communistic dictatorship, or the post-revolutionary experience of Russia under Stalin. And it is also true that for every example of economic success among the authoritarian regimes of the Third World there are several examples of failure. The distinctive feature of dictatorship is that, by its very nature, it is unaccountable to most citizens and their representatives. Although this may seem like an advantage when unpopular decisions must be taken that would be in the public interest, it also means that economic policies which hurt society generally but benefit a "crony elite" are immutable to change, at least through constitutional means.

In contrast, democratic pluralism can and does provide an important discipline on the performance of governments and officials. Democratic pluralism means a political and legal system that allows citizens to assemble and to speak out against and remove from office governments that do not serve their interests, while protecting their human and civil rights so that they can perform those responsibilities. Unless one is willing to believe that politicians and bureaucrats are inherently benevolent and wise, democracy is ultimately necessary for successful economic performance. In the final analysis, elections allow citizens (who may on occasion be confused about cause and effect) to replace inept and corrupt officials and governments that have pursued failed economic policies. An open polity may be the single most important underpinning for an open economy, in the sense that diffusion of political power, ease of entry and representation in the political arena by alternative economic factions, the fair rule of law, and clear limitations on the powers of and access to governmental officials all facilitate the growth of decentralized and private markets. Productive economic reforms and capitalism flourish best in a climate of freedom and diffuse political power. In turn, diffuse political power is alive and well in a world of ample mobility and widely diversified asset portfolios.



## **Prescriptive Paradigm**

To change the relative costs and benefits of adhering to old constitutions, institutions, and policies, it is generally necessary to form coalitions that stand to benefit from reform. In this context, what are the basic characteristics of a *paradigm* that allows meaningful prescriptions to be assessed? This paradigm must recognize that power is distributed between the various interest groups and that the maldistribution of power can blunt any and all reform efforts; it must recognize that governments can have some separate autonomy and can seek "leadership surplus"; it must provide an internally consistent framework which admits the possibility and necessity of accommodating various interests; it must conceptualize the bargains, pacts, compromises, and efforts that are undertaken to shape policies that are acceptable, not only to those who have the greatest capacity to obstruct the policy but also to others who have stakes in the outcome; and finally, it must be the basis for an integrative frame that recognizes the joint determination of both predatory and productive governmental interventions.

Some of the above characteristics are self-explanatory, and some require elaboration. Leadership surplus is a crucial concept in this prescriptive paradigm and provides an alternative hypothesis to the theories advanced by Stigler, Becker, and others. In essence, leadership, much like institutions, can be induced by economic phenomena or external crises. What makes leadership for reform possible? Or equivalently, under what circumstances will individual agents and interest groups modify their rational self-interest and subject themselves to the "public interest?" Here, we can draw from other disciplines, particularly social psychology which has offered the hypothesis that interest groups are surprisingly willing to engage in obedience contrary to their own convictions when there is only a gradual escalation in actions they are asked to take. With each escalation, their previous action sets the norm for their current behavior. For those agents who have the power to obstruct reform, predatory policies can be offered as political compensation.

In the prescriptive paradigm, current policies are viewed as some rational outcome of the political-economic process—conditional, of course, on the constitutional and institutional structure. This political-economic process is one where the public sector plays a crucial role and in a fundamental sense, must be, part of the coalition that supports reform. In any organizational structure that might arise, the public sector is naturally exposed to attempts by various interest groups to exert their influence. In this framework, if all power does not reside with the "leadership" pursuing the public interests, "organizational failures" naturally arise. Accordingly, the prescriptive paradigm must balance market failures with organizational or collective action failures.

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

### **Concluding Remarks**

Appropriate answers to the core constitutional economic questions will allow a country to find a desirable path to get from "here" to "there." It will admit practical prescriptions for economic reform that take the political environment into account. In some cases, it will prove necessary to compensate interest groups with the power to impede reform. In other cases,

an opening of the political system to the broader representation of alternative interest groups will prove to be the only means for sustaining effective economic policies.

Solutions at the constitutional core will allow the appropriate mix of both productive and predatory policies to endogenously emerge. The mix of policies must be comprehensive, covering not only policies for the agricultural sector but fiscal, monetary, exchange-rate, competitive, trade, privatization, as well as other policies. If the constitutional core is properly structured, we will not find privatization emerging without effective liberalization or the issue of ownership dominating an appropriate restructuring of incentives. Moreover, given the emergence of effective leadership pursuing the public interest, an appropriate response to the core questions can be expected to provide the foundation for endogenously determining the *sequencing* of reforms that will enhance credibility and sustain economic growth.

For the prescriptive space advocated here, there is much useful theory and empirical evidence. There are, of course, gaps; and there is much to be learned about the relationship between open, democratic societies and open, liberal economies. Furthermore, there is much to be learned about how democratic pluralism can provide an important discipline on the performance of governments and officials in setting economic policy as well as the role that democratic institutions play in diffusing political and economic power. As a result, for those of us who are interested in these issues, we are witnessing in Eastern Europe perhaps the greatest experiments of this century on constitutional economic reform, institutional change, and the endogenous political-economic determination of public policy. In the final analysis, any prescriptions that we advocate as a profession, based on previous theories, empirical evidence, or new developments in economic thought, must heed the advice of the current IMF Director, Michel Camdessus,

". . . economic growth, in its broadest sense, is too rich in meaning, too complex, and too essential to mankind's future to be left only to economists."