

ECONOMIC REFORM WITHOUT RULES OF THUMB

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When analysts look back at the last 15 years or so, they will be confronted by an interesting paradox. Economists have been more influential during this recent period in the design of development policies than probably at any other time in history. The policies of central planning, dirigism, and import substitution, which many recently independent countries adopted in the 1950s and 1960s could be chalked up to the ideas of communists, Fabian socialists, and nationalists. The policies of liberalization and openness that countries increasingly adopted in the 1980s—the so-called Washington Consensus—was supposed to represent instead the victory of economists over populist politicians and rent seekers. The paradox is that the economists' victory did not turn into a victory for economics. In fact, the last two decades have proved quite dismal for the practice of the dismal science in the tropics. With very few exceptions, countries in which the well-read (i.e., US-educated) economic technocracy gained the upper hand turned in performances that were worse than those obtained prior to the 1980s. Latin America perhaps stands out as the most telling exhibit of this. And where were the biggest successes? In places like China and Vietnam, where the ideas of Western economists, to the extent that they were listened to at all, lost out to those of more practically oriented policy makers.

The puzzle is not, “why did economics fail us?” but “why did economists get so confident as to issue blanket recommendations that could not be easily derived from first principles?” After all, much of the Washington Consensus—in its original and augmented versions—cannot be directly deduced from proper economic analysis. Any graduate student in economics knows that liberalization, privatization, openness to trade, and the other strictures in the Washington Consensus cannot be *unconditionally* expected to produce economic benefits without a long list of unlikely conditions being satisfied (complete markets, absence of externalities, full information, etc.). Joe Stiglitz's work, which any graduate student who was properly educated in the 1970s or later should have internalized, showed that markets are not “constrained efficient”—i.e. do not produce the best possible outcomes even if we assume the informational imperfections cannot be remedied. But of course the basic logic goes back to Pigou and other predecessors. The relationship between so-called “second-generation reforms” and economic analysis is even more distant. There is nothing in economic theory that should have made economic technocrats think that Anglo-American institutions of corporate governance or “flexible labor markets,” to pick just two examples, produce *unambiguously* superior economic performance when compared to German-style insider control or institutionalized labor markets.

Upon closer scrutiny, what passed as “state of the art” thinking on economic policy turns instead to have been based on some crude rules of thumb. More often than not, the advocacy of simple panaceas was based on one or more of the following pathologies:

- Poor empiricism. South Korea has done better than North Korea, and Burma's path is hardly one that leads to prosperity. Therefore we know markets do better than central planning, and trade is better than autarky. But it takes a huge leap of faith to go from this to the conclusion that one can't go wrong by privatizing, liberalizing, and opening up as much as possible. Even in areas where the empirical record appears clear, closer analysis reveals major flaws. Try running a standard growth regression with trade barriers on the right-hand side, or any other direct policy variable for that matter, and see if you get the right-signed significant coefficient on your first try. Analysts who focused only on those elements of China's or South Korea's experience that fit their priors—namely these countries' turn towards markets and outward orientation—missed out the larger story—that these were massively heterodox experiments.
- Implicit political theorizing. Economists *qua* policy advisors are great believers in simplicity, rules-of-thumb, uniformity, and arms'length relationships between governments and their private sectors. Why? Not because of economic theory or empirical evidence, but because of unexamined and untested assumptions about the underlying political economy. Governments are run by crooks, so tie their hands; bureaucrats are beholden to rent-seeking private agents, so ensure nondiscretion and apply uniform taxes and incentives; domestic political systems cannot be trusted, so import laws and institutions from abroad; external influences are always more benign than domestic ones, so ensure maximum openness to international trade and investment; reformers have a limited "honeymoon period," so implement reforms as quickly as you can. Economists ended up practicing public administration without license.
- Lack of institutional imagination. No Western-trained economist would have been able to come up with China's household responsibility system or township and village enterprises—institutional innovations that lie at the core of the Chinese miracle. Privatization and across-the-board liberalization would have been the recipe offered by any economist from Washington (or Cambridge, Mass.) asked to offer advice to the Chinese government in 1978. Only with hindsight can we see that the Chinese innovations were the functional equivalent of much more demanding reforms.

I am not saying that economics works differently in different places. Economics allows us to make contingent statements—statements of the form “if conditions *a*, *b*, *c*, obtain, then policy *x* is likely to produce the following consequences.” In practice, the need for a predicate was ignored too often. The result was that governments were confronted with an undifferentiated policy agenda that was supposed to be good for all countries at all times.

It is also not the case that there aren't some policy universals. Property rights and the rule of law are important so that investors--both current and prospective--can expect to retain the return to their investments. Private incentives need to be aligned with social

costs and benefits if productive efficiency is to be achieved. Macroeconomic and financial stability require debt sustainability, prudential regulation, and sound money. Any economist can profitably mouth these words to his/her hosts immediately upon arrival in a foreign land, without fear of going astray. The trouble is that these universal principles of sound economic management are not operational as stated. They do not map into clearcut institutional arrangements or policy prescriptions.

For example, the principle that property rights should be protected implies very little about what is the best way to do this under a society's existing institutional preconditions. It certainly does not imply that a system of private property rights and Anglo-American corporate governance is the right approach for all countries at all times. Look at the tremendous amount of investment and entrepreneurial activity that China has managed to elicit through a hybrid system of property rights and a legal regime that is as far as the Anglo-American system as one can imagine. Similarly, the principle that private incentives should be aligned with social costs and benefits hardly results in unconditional support for policies of trade liberalization, deregulation, and privatization that are the cornerstones of the Washington Consensus. The easiest exercise in the world for a graduate student in economics is to write down a model in which trade restrictions or financial controls are welfare enhancing. Finally, debt sustainability, fiscal prudence, and sound money are also obviously compatible with diverse institutional arrangements.

For economists who care about development policy, the challenge as we look ahead is to work out the mapping between these universal principles and their operational implications in specific locales. It is to fill out the predicates, conditionals, and contingencies, so that we can specify more completely than we have been able to do what kind of countries should adopt what types of policies. And failing that, it is to stop pretending that we have the answers.