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On the Philosophical, Political, and Methodological Underpinnings of Reform

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Several developing and transition countries implemented policy and institutional reforms in the last quarter of a century. Since the late seventies, and specially in the eighties and nineties, there has been a widespread move toward more market-oriented policies and institutions, particularly in Latin America, South and East Asia, the former Soviet Union and the former socialist economies of Eastern Europe.

The scope of the first rounds of market-friendly reforms was rather limited in light of what is understood by reform today. In the late seventies, policy initiatives mostly focused on the “liberalization” of the financial and trade sectors. In the eighties, under the aegis of what would later be known as the Washington Consensus (WC) view, the list of policy recommendations on the agenda significantly enlarged, encompassing trade, capital account, industrial, divestiture, financial, and macroeconomic policies. This agenda was audacious at the time because its implementation implied the abandonment of the development strategy that developing countries had been pursuing in the post-World War II period. But, the agenda still concentrated on policy reform. The references to institutional and political economy issues were scattered and ad hoc. As time elapsed and experience with reform accumulated, however, the number and scope of items on the reform agenda continued to grow steadily to the point that the WC became just one part of a much broader reform agenda in which the inducement of institutional change took center stage. Three facts were decisive: first, the de facto necessity to re-organize the institutional structure of post-communist societies practically from scratch after the fall of the Wall; second, the repeated occurrence of currency and financial crises and episodes of financial contagion among “emerging” countries; and, third, the fact that countries that at least apparently followed similar economic policies had substantially different economic outcomes. It was hypothesized that the crises in countries with apparently sound fundamentals and the failures in the case of some “early bird” reformers were due to the negative influence of “bad” institutional environments on “good” policies.

The widening of the agenda resulted in the design of progressively more ambitious programs, which were willingly instrumented by reformers who did not hesitate to promise their constituencies sizable improvements in economic performance. In the late nineties, however, the reformers’ conviction weakened while constituencies seemed less willing to wait for delivery. This suggests that the outcomes of reforms may not have lived up to their expectations and many stakeholders may have had little or no participation in the reform process in spite of the generalized move toward more democratic forms of government in the eighties and nineties. The increased demands for a better understanding of reform that we see at present, thus, came as no surprise, although it goes without saying that not all participants and stakeholders have the same motivation for demanding a better understanding of reform. In some cases, it is assumed that a better understanding will help improve the ongoing process (the “Washington” and “committed-reformers” view), while in others, it is believed that such an understanding should result in a drastic change in the present strategies (the anti-globalization view).¹

¹ For a clear statement and interesting discussion of the opposite positions of the pro- and anti-globalization views, see the transcript of the IMF Economic Forum: Is Global Inequality Rising? (IMF. 2002b)

To satisfy the rising demand for “understanding reform,” however, is an analytically complicated matter for many reasons. First, although “reform” is becoming one of the most widely used words in debates on development, it is not clear whether everybody defines it in the same way (as is the case with other frequently used words, such as “globalization”). “Reform” means different things to economists and social scientists who sustain diverse approaches and models. Second, reform programs vary widely in intensity and scope across countries and time, and the goals may be very different: from poverty reduction to increasing efficiency and promoting capitalism. Third, interest groups usually seek to participate in the design of reform packages and, under certain circumstances, the reforms may become an instrument for specific coalitions to pursue their own interests (for example, using the reform process as an instrument to gain/retain power independently of its effects on, say, welfare or freedom). Fourth, a reform is not a once-and-for-all event but rather a dynamic process. Therefore, it is very difficult to determine when a reform begins and ends and this makes it very difficult to evaluate the extent to which the expectations of society have been fulfilled, to assess the quality of the results achieved, and to draw conclusions on the future direction of reform efforts.

The main purpose of the paper is to contribute to the demand for understanding reform. In order to circumvent the problem of what reform actually means, we adopt a pragmatic view. We assume that the “reform to be understood” refers to the models and programs actually implemented and to what occurred to reform attempts in the last quarter of a century. Thus, we interpret “reform” as the movements towards more market-oriented economic systems (usually, but not necessarily, in the context of more open political systems). In addition, we will consider the myriad of questions raised by reform experiences in light of three core questions, which are key to a pragmatic approach: why reform?; what kind of reform?; and, how well the reform performed?

Our strategy for a better understanding of reform consists of three steps. The first step (Section I) describes and analyzes how the underpinnings and the concept of reform actually evolved from the mid-seventies. We try to highlight the interaction between facts and ideas. As a result of this first step we identify a set of unsettled questions which we hold key to facing the challenges of reform in the near future.

The second step consists of the analysis of such questions. We begin with a basic query: What should the goals of reform be? We consider the divergences that the answers of the different philosophical and analytical approaches to development show and the trade-offs between goals (Section II). Then, we discuss the linkages between the polity and institutions, emphasizing the interactions that arise in the context of democratization and reform (Section III). Finally, we address a set of unresolved questions that are closely associated with the international dimension. We focus on two factors that critically constrain the reform efforts of developing countries and give rise to hard policy dilemmas: the asymmetric way in which developed and developing countries integrate in the global economy (Section IV) and the difficulties to find appropriate institutional arrangements (at both international and domestic levels) to cope with the instability of international financial flows (Section V).

Our third step (Section VI) summarizes the findings and draws conclusions on understanding reform. We systematize our conclusions on the basis of the above three core questions : why reform?; what kind of reform?; and, how well the reform

performed? At the analytical level, we identify areas in which more research is pending. At the policy level, we discuss a set of problems that should be more open to public deliberation in both reforming countries and public international organizations.

The problems posed by the reform processes give rise to complex methodological, political, and philosophical questions, which probably do not admit precise and single answers. The issues are value-laden and politically sensitive. This is why we will make an effort to understand the reforms as if we had no preference for any one reform model. We will approach them as if we were about to begin our journey from behind Rawls's veil of ignorance (Rawls, 1971) (as far as such a thing is possible). But, even if we do not succeed in this regard, we believe that these issues are worth debating explicitly because, as Amartya Sen so well stated, it is better to be vaguely right than precisely wrong. We screen the arguments used to justify policy choices in terms of models and values and make an effort to integrate the political economy and institutional dimensions.

I. From the Washington Consensus to High-Quality Growth

In the last three decades, the conception of “reform” evolved from just another way to refer to a set of trade and financial policies aimed at ameliorating the anti-trade bias and financial repression that characterized development policies in the post-war period to the present all-embracing attempt at managing and driving institutional change. We will analyze this evolution in order to show the role some key philosophical, methodological, and political underpinnings of reform play. Furthermore, we will study how “real world developments” (i.e. shifts in the international scenario, political and financial crises in reforming countries) induced changes in the conception of reform. We conclude the section by identifying a set of problems that are critical to improving the design and efficiency of reform packages.

The Rise of the Market-Friendly Approach and the Washington Consensus

In the post-war period development policies were dominated by the idea that industrialization was the key to achieving sustained growth. Additionally, policy makers were convinced that the state should play a critical role in societies that lacked a strong entrepreneurial class and that had shallow or missing markets. In accordance with this vision, the state directly concerned itself with production in an attempt to accelerate capital accumulation and to acquire new technologies. Likewise, economic policies showed a bias in favor of the urban sector and manufactures (specially import substituting sectors). To influence resource allocation in the desired direction, the state privileged tools like the manipulation of relative prices, protectionism, and intervention in the process of financial intermediation. The developing countries’ enthusiasm with this approach, however, lost momentum progressively, basically because it failed to deliver its most important promise: sustained growth and development (Behrman and Srinivasan, 1995; Waelbroeck, 1998; Adelman, 2000).

Since the early seventies, a flow of analytically solid and empirically well-founded studies criticizing post-war development strategies began to emerge and, at a certain point, the evidence accumulated induced a Copernican change in the approach to development policies.² The first ambitious programs of market liberalization were launched in the Southern Cone of Latin America. But it was from the mid-eighties on that an ever growing number of countries adopted policy packages inspired in the new paradigm while reformers became increasingly ambitious. In fact, from the standpoint of the present, the liberalization attempts of the seventies appear to be timid, trembling first steps.

In the new paradigm, the faith in industrialization was replaced with the confidence in markets and the creativity of the private sector. The positive agenda of economic policy was synthesized in the recommendations of the so-called Washington Consensus (Williamson, 1990). The 1991 World Development Report, in turn,

² Krueger (1995) offers a good overview of the analytical developments that led to this Copernican shift, although the emphasis is on trade issues. For a survey of the studies that criticize the financial strategies of the post-war period, see Fry (1988).

presented and developed in detail the policy changes that a “market-friendly” reform should implement. The agenda also had a component of Schumpeterian creative destruction: According to the diagnoses of the Washington Consensus, it was critically important to do away with the old policy instruments and organizations that had been tailor-made for the ancient regime. This implied that the reforms should go well beyond mere trade liberalization and financial market deregulation that were the hallmark of the Southern Cone liberalization attempts of the seventies (Fanelli, et al., 1992). It called for deep changes in the rules of policy making and the structure of property rights, ranging from divestiture of public firms to price liberalization and changes in the macroeconomic regime. It comes as no surprise, then, that the expressions “Washington Consensus” policies and “structural reforms” began to be used interchangeably in economic policy discussions.

The comparison of the divergent growth experiences of the East Asian Tigers and Latin American countries was a privileged source for the new paradigm’s hypotheses about the determinants of long-run growth and the welfare costs that policy distortions may induce via their negative effects on resource allocation. The success of Korea, Taiwan, Hong Kong, and Singapore was basically attributed to openness and the creation of a market-friendly environment. It was natural, then, to assume that the ultimate purpose of the structural reforms should be to create a market system as free of artificial segmentations as possible. On the domestic side, privatization, the elimination of financial repression, and deregulation were the most important instruments, while the external side focused on capital and current account liberalization. The benefits would come in the form of strong productivity gains. The first studies stressed the static efficiency gains that stronger competition in enlarged, segmentation-free real and financial markets would create, although the emphasis was later placed on specialization, scale, and dynamic effects (Krugman, 1992, Rodrik, 1995). Growth capacity would be enhanced via the more rapid accumulation of physical assets, human capital, and knowledge. The integration in the world economy played a critical role to the extent that the opening of the economy was envisioned as a powerful means to enlarge markets, to increase competition, and to gain access to both external savings and new technologies (Krueger, 1995).

This “standard view” about structural reform that crystallized at the beginning of the nineties, nonetheless, was not free of criticism.³ One important challenge came from academics who had carefully screened the experiences of successful Asian countries. The bulk of the disagreement had to do with three points: the roles of the state, of industrial policies, and of the financial system in a context of pervasive market failures. As a result of the debates, many caveats were incorporated into the mainstream view. The *East Asian Miracle*, published by the World Bank in 1993, is a good example of the notion that a market-friendly view means much more than just getting the prices right.

The most difficult challenges to the standard view, however, originated in the real developments in reforming countries. It is important, in this regard, to take into account the historical context of the early nineties. To a great extent, the search for a better understanding of what makes markets work well was motivated by the need to satisfy the pressing demand for better reform technologies in the former socialist

³ See Rodrik, (1995) and Stiglitz (1993) and the references therein.

countries where the transition to capitalism was facing serious obstacles. Williamson (1996) insightfully pointed to the weaknesses of the WC's recommendations for guiding the transition. He stated that "getting the property rights right" seemed to be more responsive to the pressing needs for reform in Eastern Europe and the former Soviet Union but that, at the same time, privatization could not be the sole prescription. For one thing, the meaning of "privatization" in the transition countries had turned out to be ambiguous. The process of clarifying property rights and the introduction of correct incentive structures was proving to be much more complex than expected, in view of the conflicts that had broken out between the interests of different stakeholders. Williamson concluded that there was a more general need to "get the institutions right," of which property is only one part and that getting the property rights right is too narrow a conception of institutional economics.

The WC tended to downplay the importance of these problems because it implicitly assumed that the main obstacles to growth were the domestic policies inspired in the import substitution model, which were biased toward interventionism. Once these policies had been removed, growth and successful integration would result. The analysis of the conditions under which the polity could successfully remove the existing obstacles and the likely appearance of path-dependence phenomena were largely absent. To be sure, the need to complement the WC with political economy considerations was expressed from the very beginning. But it was recognized that the political economy of policy determination was still in its infancy (Krueger, 1995). In the nineties, the bulk of the political economy discussion centered on the issue of big bang vs. gradualism, but there were no clear-cut conclusions (Corbo and Fisher, 1995). Besides, on many occasions the attempt at making the factors that determine policy choices endogenous by introducing institutions into the analysis ended up pushing the problem one step backwards. The need for the reform to ensure the right policies was transformed into the need for establishing "appropriate" institutions that would, presumably, produce good policies.

The next real world challenge to the WC comes from the macroeconomics side. The Mexican crisis in December 1994 and its repercussions called attention to the fact that the implementation of reforms and, specially, the financial integration with the world economy might have been more complicated than what had been expected. In fact, the Mexican crisis was not the first to affect a market-liberalization process. In particular, the Mexican financial crisis cum balance-of-payments disequilibria showed features which were very similar to those observed in previous liberalization attempts in the Southern Cone (Diaz Alejandro, 1985; Taylor, 1983). In this case, the crises were attributed to a problem of misconceived sequencing between financial, trade, and capital account deregulation (McKinnon, 1991). But beyond this, what made the Mexican crisis unique in terms of "signaling" a problem were two facts. First, it was the first large post-Washington Consensus crisis that occurred in a country that was not undergoing a particularly difficult period, such as a regime change from socialism to capitalism or a highly unstable situation (which could include armed conflicts) like some African countries that had implemented structural adjustment programs. Second, it was largely unexpected. This explains the international community's interest in drawing "lessons" that the multilateral institutions engaged in structural reforms in other countries could apply. In this regard, the most relevant lessons were that capital movements can be volatile; that it was necessary to preserve financial stability based on good supervision and adequate prudential regulations; and, that it was necessary to

avoid a large current account deficit that could be difficult to finance (see, for example, Calvo and Mendoza, 1996). In addition to the lessons, however, some researchers raised the question of whether something was missing in the WC in particular regarding the role of capital movements, its volatility, and the occurrence of irrational phenomena such as contagion and self-fulfilling prophecies (Stiglitz, 1998).

The perception that something might be missing in the WC approach deepened after the Asian crisis in 1997 (Stiglitz, 1998). These crises occurred where they were least expected: in some of the East Asian Miracle countries, that is, countries that had shown very high growth rates for an extended period of time and generally had reasonably good macroeconomic management and open economies. They were unexpectedly experiencing macroeconomic and financial problems that appeared to be relevant only in Latin America, some transition economies, or countries like Turkey.

No wonder these facts gave rise to a vigorous debate among macroeconomists. Feldstein's (1999) lessons from the debate are highly representative of the opinion in the circles in which the consensus was first established. He identifies three causes for the crises in Korea, Malaysia, Indonesia, and Thailand:

- Large current account deficits
- Excessive short-term foreign currency liabilities
- Weak banking systems

After stating that there is no substitute for sound economic policies, he specifically recommends:

- Avoiding excessive deficits
- Improving regulations.

These lessons are consistent with those drawn from the Mexican crisis and are not new to those familiarized with policy debates in Latin America. However, he also affirms something which is highly characteristic of the new fears. He argues that political and business leaders in emerging market countries may rightly ask themselves what can be done to reduce the risks of a crisis. On the one hand, there are powerful forces of market contagion, shifts in risk aversion, and irrational speculation. On the other, the IMF and other international organizations do not have the resources to act as lenders of last resort.⁴

Following the Mexican and Asian crises, other large emerging countries that had implemented important reform programs were affected by financial and macroeconomic problems, most notably, Russia, Brazil, Turkey, and Argentina. The recurrence of "twin crises" (concurrent currency and financial crises; Kaminsky and Reinhart, 1999) posed difficult analytical and practical challenges to the design of reform programs. As Krugman put it, "The truth is that nobody really imagined that something like the Asian

⁴ In light of these, Feldstein advises emerging market countries that want to prevent sharp currency declines to provide their own protection through increased liquidity and to build much larger foreign exchange reserves than countries have traditionally held as an important source of protection, flexibility, and confidence. Of course, he recognizes that this option is expensive. Nevertheless, he believes that it can be far less costly than the damage coming from currency crises.

Financial crisis was possible, and even after the fact there is no consensus about why and how it happened” (Krugman, p.1, 2000).

In view of these developments, many questions naturally arise: What are the costs of global instability in terms of sustainable development? Is it possible to design better institutional arrangements at the international level to reduce these costs? Is it fear that poor countries allocate badly needed foreign exchange to protect themselves from volatility that can be, to a certain extent, considered a negative externality of globalization? Is there room for developing international public institutions capable of supplying global coordination that seems to be in short supply? How can we solve collective action problems associated with sovereign debt restructuring?

These questions reflect a concern for both the efficiency of the institutional arrangements that govern the global economy and the way in which developing countries integrate with that economy. In the early versions of the market-friendly paradigm, the functioning of the global economy per se was not a source of concern. It was assumed that the integration with the international economy opened a window of opportunity since “the experience of the East Asian NICs convinced virtually all observers that an outer-oriented trade strategy had been an important contribution factor to rapid economic growth. Certainly, high savings and investment rates and a variety of other factors had also contributed, but the rapid growth of exports was held to be key” (Krueger, 1995 p. 2540).⁵ Because of the succession of crisis episodes, however, the idea that the international economy could be in itself an important source of instability for emerging capital markets –via contagion and episodes of coordination failures– was gradually incorporated.

In fact, many researchers believe that the globalization process shows such marked asymmetries between developed and developing countries that one may doubt whether the window of opportunity is really open. According to Alan M. Taylor: “The Industrial Revolution implied wherever it spread –and equally, where it didn’t– as countries traded among themselves, exchanging manufactures for primary products and vice versa. This was a fundamental international division of labor that had not been seen before on such a scale, and it also heralded the Great Divergence of incomes and productivity in the last two centuries” (Taylor, 2002, p. 6). After reviewing the main characteristics of the present process of globalization he concludes that whether globalization broadly construed will result in the equalization of the workers’ efficiency levels, and whether trade might be one of its channels remain to be seen. One specific source of concern for this to occur is protectionism. Many observers see the real possibility of a retreat into protectionism in rich countries because “While preaching trade, the rich countries have erected obstacles precisely in those areas where poor countries have a comparative advantage” (Stern, 2002, p. 2). Other barriers frequently mentioned in the literature are the severe restrictions on migration flows and the obstacles for technological transfer that make the catching-up process more difficult.

⁵ Of course, we are not implying that the WC recommendations did not take into account the role of balance-of-payments disequilibria because that would simply be wrong. Indeed, many of the market-oriented structural programs implemented in the eighties sought to ensure stability after the occurrence of the debt crisis. But, before the mid-nineties the bulk of the policy recommendations to ensure external sustainability referred to the management of the domestic economy with practically no reference to the governance of the international economy.

Changing Goals: Second Generation Reforms and High-Quality Growth

The WC policy recommendations for each new post-Mexican crisis were amended on the bases of newly learnt lessons. This practice, in fact, had begun with the failure of the Southern Cone liberalization attempts when a series of lessons on “sequencing” were drawn (Fanelli and Frenkel, 1993). For example, at that time, a consensus was built on the fact that trade liberalization should go first and that stabilization should precede structural adjustment. These lessons on sequencing, however, tended to be ignored in the reform programs implemented by socialist countries, among other things, because many observers recommended a big-bang strategy as a means to ensuring the irreversibility of the process. As Corbo and Fisher (1995) put it, in many transition countries practice was well ahead of theory.

But, beyond the fact that the experience of former socialist countries and the successive crises called the world’s attention to the challenges that reforming countries were facing (specially in the media), other less impacting, though no less pressing, problems progressively appeared in the eighties and nineties as the process of structural reform unfolded. The most relevant were: the deterioration in social conditions of specific groups; the sluggish progress in poverty alleviation; environmental degradation; the difficulties to establish the required regulatory framework; the lack of transparency; rent seeking; political instability; and, corruption. Of course, these problems were not prevalent in all reforming countries, and some were doing much better than others. But the point is that the same kinds of difficulties tended to appear in different settings, which suggests the existence of some kind of “hidden characteristic” affecting the reform process.

The magnitude of the challenges policy reform posed increased concern among policy makers and academics alike that the strategy of adding successive lessons was not necessarily optimal and some changes would have to be introduced into the design of what had begun to be called the “first” generation of reforms (FGR). The response was to deepen and complement the First Generation of Reforms by means of a Second Generation of Reforms (SGR). One main purpose of the SGR would be to improve the quality of growth by attacking poverty and by promoting good governance and transparency. According to Wolfensohn (1999), the President of the World Bank, the SGR focuses on two questions, first, the structure of the right institutions to develop the institutional capability for reforms and, second, the issue of ensuring two primary goals of economic policy in the developing world: sustainable growth with poverty alleviation. Under the SGR approach, the World Bank and the IMF should coordinate efforts to better pursue both FGR and SGR objectives. Reforming countries, in turn, would have to improve the quality of policies and institutions (transparency, governance) (Camdessus, 1999, Rodrik, 1999)⁶.

The explicit mention of both growth and poverty reduction represents a significant change. The FGR references to the “quality” of growth and poverty reduction were scattered and unsystematic. For example, as late as the mid-nineties, Corbo and Fisher expressed that “Structural adjustment is a process of market-oriented reform in policies and institutions, with the goals of restoring a sustainable balance of

⁶ One problem for organizations such as the World Bank is that the new agenda has many political implications and its shareholders do not want the Bank to interfere with their politics. I am grateful to Gary McMahon for this comment.

payment, reducing inflation and creating the conditions for sustainable growth in per capita income.” (Corbo and Fischer, 1995, p. 2847). They make no mention of development in general, poverty, distributional aspects, or the environment. The reference that Collier et al. make of the role of the World Bank in their account of fifty years of development well illustrates the changes that occurred in the approach to development. “As thinking about development has changed, so too has what we have come to expect from development agencies such as the World Bank. At the time when much of development thinking placed planning at centre stage, the Bank helped finance the big projects which were at the heart of many of these plans. When the emphasis shifted to the policy environment, particularly getting prices right, the Bank promoted stabilization and trade liberalization and financed structural adjustment. Now, the agenda has stronger governance and institutional elements, including helping societies provide effective public services oriented to the poor. This calls for a different role for the Bank: one that puts still more emphasis on learning and knowledge. In many cases communities have to learn for themselves how to design effective institutions that work in their setting” (Collier, et al. 2000, p. 3).

We can hypothesize that, as in other aspects of the WC, the changes in the views about the goals that reforms should pursue are also associated with “real world” developments. That is, the changes may be associated with the fact that the WC fell under scrutiny for the very same reason as the older paradigm: It failed to deliver some important promises. In effect, in a significant number of reforming countries in Latin America, Asia, East Europe, and Africa sustained growth was far from achieved and many of them experienced important macroeconomic disequilibria and financial turmoil. Although there are many successful cases (China being the most remarkable in the last twenty years), productivity increases in the developing world are far from ensuring that developing economies will catch up with developed countries. Indeed, according to the World Development Report, 2003, inequality is widening significantly between rich and poor countries and the same is happening within many countries. Poverty, in turn, is declining but is still a challenge because the bulk of the recent improvements is basically explained by China and to a lesser extent by India, while the number of very poor people is increasing steadily in Sub-Saharan Africa and by far too large. The World Development Report also called attention to a series of environmental threats. Under these circumstances, there does not seem to be much room for optimism about a rapid narrowing of the Great Divergence.

To be sure, there is always the problem of the counterfactual. Many of the countries which failed to successfully implement reforms were facing severe political and social disturbances at the time the reform was launched or were hit by sizable shocks. Hence, the lack of growth or the failure to meet other developmental goals cannot be simply attributed to weaknesses of the FGR. However, a defense based on the counterfactual argument, though logically correct, may in practice be very weak. And this may be particularly so in the political arena. One, the same argument was used in the seventies to defend the import substitution model against the insightful criticism that the neoclassical school was making of the obvious distortions that the import substitution model was generating. Two, and more importantly, the WC analytical apparatus was not well suited to integrating the study of the role of the polity. As a rule, the structural programs tended to ignore the constraints posed by political factors and the difficulties for inducing and implementing institutional change.

The Problems in Search of a Solution

Our brief journey through the evolution of the approaches to reform in the last decades suggests that some key unsettled questions remain. From the point of view of the challenges that the reform processes are now facing, the most relevant questions can be classified into four groups:

- I. What should the goals of reform be? How can we assess performance and what are the relevant trade-offs between goals?*
- II. What is the role of institutions and political constraints? Is it possible to drive institutional change? What is the relationship between democracy and development?*
- III. How can we manage the existing (and arising) asymmetries between developing and industrialized countries? Is it possible to preclude globalization from reproducing the Great Divergence?*
- IV. How can developing countries and IFIs coordinate their efforts? What kind of domestic and international financial regimes should developing countries and IFIs build in a world of contagion effects and volatile parities between the main reserve currencies?*

One way or another, these four problems have been permanently present in recent debates on the process of reform in both international public agencies and reforming countries. Some specific steps have been taken to tackle them. We can see two main weaknesses: first, the different initiatives have been taken rather independently and are not necessarily mutually consistent; and second, the SGR still largely assumes that it is possible to define a one-size-fits-all set of reforms for countries that may show very different macroeconomic settings, institutional frameworks, geographical locations, and historical backgrounds. Lack of consistency and disregard for the fact that details matter (Williamson, 1996) may ultimately derail the reform effort during the process of structural change. In the following sections we take a closer look at problems I-IV.

II. The Goals of Reform and their Trade-Offs

Although the explicit inclusion of poverty reduction in the same step with growth seems to be warranted in view of the present evolution of the developing world, the analytical and philosophical underpinnings of such an inclusion are far from clear. In effect, although there is a wide consensus that development should be the goal of reform, many observers would claim that development is not synonymous with growth and poverty alleviation. Additionally, economic theory and the practice of reform strongly suggest that it is critically important to take into account the mutual interactions and sequencing relationships between different reform initiatives and goals. Reformers usually face very difficult trade-offs between policy goals, such as those that typically arise between macroeconomic stability and growth or poverty reduction. The sequence of policy reforms chosen and the objective-ordering that such a choice implies may collide with the hierarchy between goals dictated by normative and philosophical considerations or by political constraints. It follows, then, that in spite of the consensus about development being the ultimate goal of reform, three questions merit discussion: what is the meaning of development? And, at a more operational level, what intermediate goals should be pursued to achieve development? How should performance be assessed?

The Meaning of Development

The following four definitions of development are representative of the existing approaches.

- (a) “Economic Development as distinct from mere economic growth, combine:
1. Self-sustaining growth
 2. Structural change in patterns of production
 3. Technological upgrading
 4. Social, political and institutional modernization
 5. Widespread improvement in the human condition” (Adelman, 2000, p. 1)

It is clear that were we to monitor a reform process designed in this framework, the intermediate goals to check would be associated with suitably defined targets for each of the five conditions listed. This view is representative of the “traditional” conception of development as structural transformations.

- (b) “Sustainable development requires attention not just to economic growth but also to environmental and social issues ... the core challenge for development is to ensure productive work and better quality of life (World Development Report, 2003, p. 1).”

The WDR 2003 analyzes the intermediate goals that should be pursued and expresses some consistency conditions among the goals. First, it states that any serious attempt at reducing poverty requires sustained economic growth. Second, after reviewing the threats posed by widespread poverty, widening inequality, devastating conflicts, air pollution, the shortage of fresh water, the degradation of the soil, the destruction of the forests, disappearing bio-diversity and the decline of fisheries, the

Report says that “None of these social and environmental patterns is consistent with sustained growth in an interdependent world over the long term” (p. 3). The Report discourages developing countries from following strictly the strategies of developed countries because “development strategy to date has often relied on drawing down environmental resources and replacing them with human-made assets. This was the strategy followed by today’s industrial countries” (p. 20). And there is no guarantee that such a replacement will be possible in the future because certain critical thresholds could be breached. In this regard, it is critically important to take into account the precautionary principle for decision taking under uncertainty.

(c) “Expansion of freedom is viewed in this approach, both as the primary end and as the principal means of development. Development consists of the removal of various types of unfreedoms that leave people with little choice and little opportunity of exercising their reasoned agency” (Sen, 2000, p. xii).

From an instrumental point of view, Sen distinguishes five types of freedom which are particularly important: (1) political freedoms; (2) economic facilities; (3) social opportunities; (4) transparency guarantees; and, (5) protective security. Each of these distinct types of rights and opportunities helps to advance the general capability of a person. Consequently, the intermediate goals of reform should be related to the enhancement of these five types of freedom.

(d) “Politics significantly shape economic performance because they define and enforce the economic rules. Therefore an essential part of development policy is the creation of politics that will create and enforce efficient property rights” (North, 1994, p. 366).

In this approach there are no substantive intermediate economic goals to monitor. The reform should focus on building appropriate rules for the economic game. In fact, to focus on specific variables that are supposed to be correlated with growth, such as technology or human capital, may even be misleading. According to North, “A theory of economic dynamics is crucial for the field of economic development...Neoclassical theory is simply an inappropriate tool, to analyze and prescribe policies that will induce development... When applied to economic history and development is focused on technological development and more recently human-capital investment but ignored the incentive structures embodied in institutions that determined the extent of societal investment in those factors” (North, 1994, p.359). In the same vein, Williamson (1996) states that the lessons of firm and market organization carry over to the study of development and reform.

Running the risk of being too schematic to reap the benefit of clarifying some political dimensions of reform, we can classify these definitions of development in two categories, substantive approaches (SA) and procedural approaches (PA). A reformer sustaining SA will tend to specify the substantive goals to be achieved by reform (i.e. a given reduction in poverty, certain types of technological upgrade, a minimum growth rate) and, hence, the results of the reform could, in principle, be assessed on such bases. A reformer adopting PA, in contrast, will focus on building and improving the rules of the game. And, since it is the polity that sets and enforces the rules, the reform will attribute a key role to political economy factors. The SA emphasizes the final destination of the journey toward development; the PA focuses on the construction and improvement of the tracks that are supposed to lead the economy toward the best

economic outcome. The substantivist policy maker claims to be judged by the results obtained, the proceduralist, by the quality of the track that the polity managed to build.

Although they follow distinct conceptions, definitions (a), (b), and (c) can be classified as substantive approaches to the extent that they identify development with the achievement of substantive and specific results. Besides, these results are explicitly distinguished from “mere” growth. In this regard, the first three definitions present key differences with (d), which defines development in a procedural way. Good economic performance is the outcome of good institutions and good institutions are built by good polities. Another difference with the other three is that there is no explicit concern for distinguishing development from growth. In fact, North (1994) and Williamson (1996) tend to use “growth” and “performance” as synonyms and to identify good performance with either high growth or development.⁷

The Trade-Offs

It is obvious that the SA will not deny the role of institutions in achieving developmental goals and that the PA will not deny the importance of, say, implementing special policies for poverty alleviation.⁸ The point that we wish to emphasize, instead, is that reformers inspired by the SA and the PA are unlikely to have the same policy reaction function. They will assign different values to the trade-off relationships between reform goals. That is, with respect to policies and lessons, the same set of facts and outcomes of reform under the SA and the PA can be interpreted in very different ways. For example, if outcomes are “bad” because people’s capabilities are not improving but institutions are effective,⁹ the policy maker following the PA may not perceive the need for any further change in the rules of the game. One supporting Sen’s substantive view may not accept an institutional framework that, say, defines property rights in the clearest way but generates outcomes that are in flagrant contradiction with the set of five freedoms mentioned above. On the other hand, if the growth rate is high and poverty is being alleviated but institutions are not effective, a substantivist may not see any need for reform while the proceduralist may claim that a reform is essential because a flawed institutional framework will ultimately cause the growth process to stop.¹⁰

⁷ Furthermore, the title of North (1994) is “Institutions and Economic Performance,” but the meaning of performance is not clearly defined.

⁸ We would not like to overemphasize the difference beyond what is necessary for our methodological purposes. We are grateful to Klaus Schmidt-Hebbel for calling our attention to this point.

⁹ To be effective, an institution must be designed so that the incentives of market actors are aligned to achieve the desired outcome (see World Bank, 2002 and the references therein).

¹⁰ Some dimensions of the Chinese experience may illustrate the kind of dilemma that the development process poses to both the SA and the PA. After reviewing the important market-oriented reforms introduced in China, Collier et al. (2000) call attention to the fact that “We have focused here on China’s growth from the perspective of reform and institutions. It is important to recognize that China entered the reform period with very strong education and health conditions for a country of its income.” (p. 7). But, if initial conditions are important to explain China’s growth path, as the authors rightly point out, it is clear that it would be very difficult for an observer adopting a pure PA to explain China’s economic “performance” only in terms of rules of the game and, more precisely, in terms of property rights that “get incentives right.” Should we, then, be pragmatic and say that some previous policies were functional to growth to the extent that they led to the “primitive” accumulation of human capital needed for the big push? Or should we better defend the counterfactual argument that with a better definition of property rights in the past China would have grown even faster (and, how much faster)? But, then, what is so particular about China that the country can grow fast under any system? Are we overlooking something about the “deep parameters” that determine growth? Even if we adopt a pragmatic view, a substantivist

This suggests that the substantive approach is, in principle, more permeable to pragmatism: Once the goals are set, “it does not matter if the cat is black or white as long as it catches mice.” In the case of the procedural approach this pragmatic view would be incorrect. If institutions (including those corresponding to the polity) are not effective, good outcomes will ultimately be unsustainable. Both views, however, present vulnerabilities. In pursuit of development goals, an overly pragmatic economic policy could have deleterious effects on political freedom or human rights. In principle, this would be less likely under the PA to reform because there would be greater resources invested in building good quality institutions, which would prevent such deviations. Of course, since a substantive approach is compatible with distinct definitions of development, a person that believes in definition (c) would not accept a reform process that disrespects certain basic rights. But we cannot ignore that the reforms that deliver a high growth rate and poverty alleviation tend to be classified as successful, independently of other considerations. The PA, on the other hand, is vulnerable to dogmatism. It has frequently been observed that reformers strongly emphasize the fact that the rules of the game are the correct ones and, on that basis, tend to disregard the arguments of the critics and argue that the critics lack an understanding of the blueprint of reform. In this case, one could say that the problem would not be that reformers ignore that institutions matter (Williamson, 1996) but that they assume that institutions matter too much.¹¹

In practice, however, reforms are not normally based on either a pure SA or a pure PA. Eclecticism in this regard is the rule rather than the exception.¹² This, in principle, is a healthy practice that may be useful to avoiding both extreme pragmatism and dogmatism. Eclecticism, however, may be vulnerable to opportunistic behavior on the political side. Examples abound of reformers who adopt a substantive approach to design the reform and formulate substantive promises to the electorate but quickly shift to a procedural approach when the time comes to evaluate outcomes which do not live up to their expectations. The typical argument is that the rules of the game are well

observer may ask whether China’s high “performance” can really be considered to be “development” taking into account the requirements of, say, definition (c). The difficulties to assess future prospects are no less important. Property rights in China are still fuzzy, the financial system has far from met, say, Basle standards, and a great number of firms are in the hands of the government. Under these circumstances, is the present high growth rate unsustainable? The SA and PA responses to these questions would surely differ. Although, to be sure, the de facto approaches used to debate on China are quite eclectic. But, then, what are the analytical underpinnings? By being eclectic, are we not running the risk of inconsistency?

¹¹The case of the Argentine financial reform may be a good illustration. Argentina adopted the recommendations of the Basle Accord and, according to Calomiris and Powel (2000) had one of the best system of regulations in the developing world. The critics, however, affirmed that these rules of the game were wrongly designed because they resulted in a high degree of dollarization of financial instruments, thereby increasing banks’ and firms’ exposure to currency risk. Adopting a procedural approach, the Argentine authorities argued that the system was strong because the rules were correct. But the system finally collapsed. How should we judge the Argentine financial authorities? Should we judge the effects of this policy just by the quality of the institutions built (prudential regulations in line with the Basle Accord, the quality of supervision, etc). Or should we adopt a substantivist stance and say that they should have taken specific measures to protect the system against currency risk in view of the lack of financial stability, even though such measures may have seemed to be at odds with certain sensible prudential regulations? (See Fanelli and Medhora, 2002).

¹² For example, although the World Development Report 2003 insists on the substantive content of sustainable development, the idea that institutions matter has not been abandoned (see specially Chapter 3).

designed and, hence, the assessment of outcome is not very relevant. And vice-versa, sometimes certain political coalitions access power on the basis of a commitment to induce a “change of regime” favoring, say, transparency and participation and, after a certain period, corruption becomes rampant and the state is captured by vested interests. If economic outcomes are nonetheless good, the elite will normally shift from the PA to a pragmatic view to praise good results in spite of wrong institutions (“roba pero hace”). This gives rise to complex political dilemmas. For example: What should a political party that is committed to market reform do, be implacable with corruption even at the risk of favoring the interests of the anti-reform party? And what about international agencies that may have given strong support to reformers at the beginning of the process? Should they interrupt financial support or not? This kind of dilemma was critical in the case of the reform in Latin America (particularly in Argentina, Peru, Brazil, and Mexico) and in many transition countries in which the state was captured by a minority which frequently took advantage of the reform to define property rights ... in its best interest.

Beyond practical eclecticism, at the analytical level, definition (d) can currently be considered to be the most influential underpinning for reform. For example, the PA to reform was clearly present in the World Development Report 2002: “This Report discusses both institutions that support growth and those that directly affect access of people left out of many market activities. It considers those institutions that provide opportunities for people and that empower them. It goes beyond the 2000/2001 Report by analyzing what institutions *do* promote growth and facilitate access and by suggesting *how* to build effective institutions. And it emphasizes how institutions can help people *make better use* of the assets they own and how to accumulate more.” (World Bank, 2001, p1). Notice that, here, growth and empowerment have replaced development as the standard for performance. And growth and empowerment are basically a question of getting institutions right. It is a procedural question. Although, of course, this raises the fundamental question of how to build the polity to create and maintain such institutions. Given that reform efforts in the last two decades have largely coincided with attempts to secure democracy, a closely related question asks what the relationship between market reform and democracy is about.

The Assessment of Performance and Welfare

Beyond the bias introduced by PA and SA, nonetheless, the assessment of the reform outcomes in terms of their contribution to development is not an easy task and give rise to complex philosophical issues. On the basis of standard neoclassical theory, we could identify welfare with utility and the satisfaction of individual preferences.¹³ This strategy, however, is not an ideal guide for evaluating outcomes in a situation in which structural reforms are being implemented. To begin with, it may be controversial to take preferences as given in a context of institutional changes because some arrangements are designed to change the structure of preferences.

¹³ One strand of the literature has tried to determine a socially optimal set of structures of exchange but the results are not widely accepted and its influence on development thinking is limited. Eggertsson (1990) is a good survey on this issue. See also Hoff (2000) and Stiglitz (2000).

More generally, many economists¹⁴ believe that we should not identify welfare with the satisfaction of individual preferences because of their distributional implications. According to Sen, the efficiency results reached in the neoclassical framework alone do not guarantee distributional equity.¹⁵ “The far-reaching powers of the market mechanism have to be supplemented by the creation of basic social opportunities for social equity and justice” (Sen, 2000, P. 146). Additionally, the interaction between institutions and distribution is not easy to grasp. For one thing, in the cost-benefit analysis typically used to make social choices, value is defined on the basis of ability and willingness to pay for a marginal unit of a commodity, and depends indirectly on the ownership of rights and wealth distribution. Additionally, cost-benefit analysis can be used to sanction policies that make some people worse off to the extent that the compensation considered is usually hypothetical. This suggests that development policies should treat distributive matters more explicitly and transparently and rely more on public debate. There are certain issues, such as the environment, that per se calls for interpersonal comparisons of welfare (i.e. across generations).

If one considers that utility and the satisfaction of preferences are not suitable to measuring welfare and that there is no clear standard to evaluate economic performance, we should recognize that “Economic outcomes may be better or worse along several dimensions. Some outcomes may make people better off. Others may show more respect for human dignity. Others may permit greater freedom. To decide which dimensions are more important requires moral judgment” (Hausman and McPherson, 1997, p. 69).

If we are prepared to assume that welfare is much more than preference satisfaction and to accept that freedom, equality, and justice are also relevant, it is necessary to adopt a broader view of the role of institutions. For example, the reform could aim at establishing rights and institutions that satisfy Rawls’s principles. This would lead to the design of institutions that will minimize the need for redistributive efforts and concentrate on the means with which individuals can construct their own good rather than directly satisfy preferences (Hausman and McPherson, 1997). Furthermore, this perspective would call for a more integrated view of institutions. According to Sen, “Even though different commentators have chosen to focus on particular institutions (such as the market, or the democratic system, or the media, or the public distribution system), we have to view them together to be able to see what they can or cannot do in combination with other institutions. It is in this integrated perspective that the different institutions can be reasonably assessed and examined” (Sen, 1999, p. 142). This raises the question of what institutions are really good for. One answer says that institutions produce the “wealth of nations” (North, 1994). But it is also true that some institutional arrangements are better than others in this regard and that the characteristics of the polity are key. This again raises the issue of the connections between institutional change and the polity and, more specifically—taking into account the typical reform scenario in the last decades—the interactions between institutions and democracy. We address these issues in the next section.

¹⁴ See, for example, Hausman and McPherson (1997) for an enlightening discussion of the issue relating economic analysis and moral philosophy.

¹⁵ According to Qizilbash (2002), Sen's approach has distanced from certain notions of “utility” and “welfare” such as “preference satisfaction” and “happiness” which are inherited from certain utilitarian philosophers and his work marks a return to something akin to the notion of a *flourishing human life* which Aristotle discussed in his *Nicomachean Ethics*.

III. Institutions and Democracy

The literature has repeatedly shown the importance of institutional factors for economic growth under differing contexts and regions (Polterovich, 1998; Rodrik, Subramanian, Trebbi, 2002). Rodrik (1996) found that nearly all variations in the rates of growth in labor productivity in Southeast Asian countries in 1960-94 can be explained by per capita income in 1960, average length of education and the index of the quality of institutions derived from surveys conducted in the 1980s. Similarly, in a sample of 69 countries, it was found that 70% of the variations in investment could be explained by only two factors—GDP per capita and institutional capacity index (World Bank, 1997). According to Holmes (1997) the major lesson that can be drawn from the recent Russian experience is that state institutions are crucial: Whereas the Soviet Union proved that the non-market economic system with the strongest state cannot be efficient, the developments in Russia suggest that the market economy without a strong state results in the “exchange of unaccountable power for the untaxable wealth” and leads to economic decline.

The symptoms of the difficulties to consolidate the institutional infrastructure in developing countries take various forms, many of which can be quantitatively measured: increases in the share of the shadow economy; declines in government revenues as a proportion of GDP; macroeconomic instability and weak financial deepening (high rates of inflation, “dollarization” and “barterization” of the economy, decline in bank financing as a proportion of GDP); inability of the state to deliver basic public goods and appropriate regulatory framework; poor enforcement of property rights and contracts and inefficient management of bankruptcies; increased crime rates. The studies that assess the quality of the global institutional setting on the bases of a measure of the trust of businesses and individuals in institutions clearly suggest that there is a high cross-country variation in the quality of institutions. For example, a global survey of firms in 69 countries on the credibility of state institutions reveals a striking gap between Eastern Europe (EE) and Commonwealth of Independent States (CIS) countries (World Bank, 1997). CIS countries have the lowest credibility and rank below Sub-Saharan Africa. Indeed, the differences in the credibility index between South and Southeast Asia and EE are less pronounced than differences between Sub-Saharan Africa and CIS.¹⁶

Stiglitz (1998, 1999) assigns a critical role to institutions in the emerging post-Washington consensus and calls attention to the fact that there exists no theoretical framework (like the general equilibrium theory for the case of well-functioning markets) within which to assess the efficiency of a given institutional arrangement and, thereby, draw normative conclusions. Hence, if we lack a theoretical framework to define the “best” set of institutions and, specifically, the “best” property rights structure, we have to face the fact that the basic structure of property rights is largely determined by the state and reflects the preferences and constraints of those who control the state. All choices made by individuals and groups who control the state are constrained by the

¹⁶ The International Country Risk Guide (investment risk index—World Bank, 2001) and the government efficiency index (WDI, 2001; Kaufmann, Daniel, Kraay, Aart, and Zoido-Lobaton Pablo, 1999) are other measures that are based on polls of experts and surveys of residents. The latter database contains separate indices for the transparency and accountability, political stability, rule of law, control of corruption, government effectiveness, and quality of regulations.

requirement to maintain power. However, the ultimate impact of institutional change on power relationships is often shrouded in uncertainty (Eggertsson, 1990). As North puts it, it is the polity that determines property rights, but “we know very little about how to create such polities”¹⁷ (1994, p.3).

Under these circumstances it is very difficult to answer the question about what are institutions good for. This is why many authors believe it is necessary to apply a more historical perspective or an evolutionary perspective to evaluate outcomes as soon as institutions come into the picture (North, 1991; Stiglitz, 2000; Aoki, 2001). But historical facts about institutional development, nonetheless, are sometimes striking. One result which is frequently highlighted is that some authoritarian regimes, like South Korea and Taiwan before the 1990s, shows institutional features which are much closer to those observed in “old democracies” than to those observed in new democracies of the “third wave” (World Bank, 1997, pp. 5, 35). This raises the question of the relationship between democracy and institutions and, more generally, between institutional change and development.

A deeper understanding of the determinants of society’s ability to build/change institutions would be particularly useful for improving the results of reform. For one thing, the reform process per se opens unusual opportunities for the authorities and various powerful groups to behave opportunistically. In practically all reform processes, and especially in transition countries, it was observed that some groups used the process of structural reform as a means to appropriate rents and to continue enjoying some of the benefits they enjoyed under the old regime. This was the case of some former managers of state-owned firms in the former socialist countries. But it was also the case of groups that had reaped the benefits of protection and state intervention during the import substitution period. In Latin America, for example, many “grupos” and foreign investors acquired monopolistic positions and varying degrees of market power as a consequence of the privatization process. Thus, some economists in Eastern European and CIS countries use the concept of “captured state” to refer to stakeholder groups that took advantage of the reform (Hellman and Kaufman, 2001; Havrylyshyn and Odling-Smee, 2000). These arguments imply that we should complement the question about what institutions are good for with the question: Who benefits from a given set of institutions?

In this section we discuss these issues and present some evidence in order to clarify how a better understanding of institutional factors and the role of the polity may help to understand reform. We focus on two issues. In the first place, we analyze the relationship between democracy and development and the “sequencing” problems that arise in the process of democratization in countries with no firm rule of law. In the second place, we examine the process of institutional change in transition countries and discuss the hypothesis that institutional capabilities largely depend on the combination of the rule of law and democracy. Specifically, we will see that the data suggest that both authoritarian and democratic regimes with a strong rule of law can deliver efficient institutions, whereas under a weak rule of law authoritarian regimes do a better job at

¹⁷ According to Elster (1989), it is very difficult to tell how norms emerge and disappear. Additionally, at any given time, we can maintain many different norms, which may have contradictory implications for the situation at hand.

maintaining efficient institutions (order) than democracies; and that democratization under a poor tradition of the rule of law may result in severe institutional difficulties.¹⁸

For the purposes of our analysis, we will classify countries in four categories. (1) *Liberal democracies*, characterized by strong democratic regimes and a firm rule of law (for example, OECD countries); (2) *liberal and liberalizing autocracies*, with strong authoritarian regimes that are liberal or liberalizing in the sense that they protect individual rights, including property and contracts, and create a framework of law and administration (XIX century Europe, the case of East Asia before 1990s, China and Vietnam today); (3) *illiberal democracies*, which are weak democratic regimes with problems to enforce law and order (most countries in Sub-Saharan Africa, the Commonwealth of Independent States, South Asia, and Latin America); and (4) *illiberal autocracies*, which are less democratic regimes with a weak rule of law (Middle East and North Africa – MENA)¹⁹.

Democracy and Development

Democracy is widely regarded to be one of the goals of development and reforms. The recent Human Development Report (UNDP, 2002) entitled *Deepening Democracy in a Fragmented World*, states that “political freedom and participation are part of the human development, both as development goals in their own right and as means for advancing human development” (p.52). There is less agreement, however, on how these goals relate to others, such as growth, more equitable income distribution, higher life expectancy, or increasing educational levels. The Report argues that there is no trade-off between democracy and growth and that democracies, in fact, contribute to stability and equitable economic and social development. In this view, the issue of the “relative price” of democracy becomes largely irrelevant. The literature, however, strongly suggests that the questions involved are far from settled. The Rawlsian tradition gives priority to democratic values. According to Rawls (1971), civil liberties, including political rights, “are not subject to political bargaining or to the calculus of social interests.” The supporters of the “Asian” values, who often trace the origins of their philosophical tradition back to Confucius, would argue to the contrary. They claim that the interests of society as a whole take precedence over the interests of the individual and, therefore, civil or political rights could in principle be sacrificed for the benefit of the community, for example, to achieve more rapid and equitable economic growth.²⁰

To be sure, the core of the debate does not target the intrinsic value of democracy but rather the “relative price” of democratic values as compared to other developmental goals. Certainly, this debate raises philosophical and ethical questions

¹⁸ Triesman (1999) argues that the current degree of democracy, despite theoretical arguments, has no significant impact on the level of corruption; it is only lengthy exposure to democracy that limits corruption.

¹⁹ According to Zakaria (1997), the most efficient institutions are found in countries with a strong rule of law sustained by either democratic or authoritarian regimes. The least efficient institutions are in illiberal democracies while illiberal autocracies appear to do better than illiberal democracies in maintaining institutional capacity.

²⁰ Sen (1997) calls attention to the fact that Lee Kuan Yew, the former prime minister of Singapore and a great champion of the idea of “Asian values,” has defended authoritarian arrangements on the grounds of their alleged effectiveness in promoting economic success.

that go well beyond the scope of this paper, whose main objective is to understand reform. Therefore, we will focus on some specific issues and facts that are strictly relevant to our purpose. In the first place, the performance of the “third wave” democracies—countries that have democratized since 1974—has been disappointing in terms of ensuring both political and other civil rights and economic and social progress.²¹ In the second place, the evidence suggests that building a democracy is a complex and dynamic process. In this regard, Zakharia (1997) calls attention to the fact that “illiberal democracies” tended to develop in those countries where competitive elections were introduced before the rule of law was firmly established. European countries in the XIX century and, more recently, East Asian countries, established first the rule of law and only then gradually introduced democratic elections (Hong Kong is the most obvious example of the rule of law without democracy). In contrast, in Latin America, Africa, and in many former Soviet Union countries democratic political systems were introduced in societies without a firm rule of law. In these societies, authoritarian regimes (including communist) offset the weak rule of law by resorting to authoritarian practices to maintain social order (lawless order), while gradually building property rights and institutions. When democratization occurs under these circumstances, illiberal democracies may emerge given that the old authoritarian instruments to ensure order have been removed and the newly developed democratic mechanisms (rule of law) that guarantee property rights, contracts and order have not been firmly established.

The academic literature on the growth/democracy relationship is extensive (for a survey see, Przeworski and Limongi, 1993; Afontsev, 1999; Przeworski, Alvarez, Cheibub, and Limongi, 2000; UNDP, 2002). According to one view in this literature, democracy can restrain growth if populist pressures for increased consumption undermine investment and block “good” economic policies and reform. It is emphasized that governments in democratic societies are more exposed to pressures from private interests. Autocratic regimes are believed to be better suited than democratic ones to resist pressures for the redistribution of income and resources coming from the poor majority of the population (Alesina, Rodrick, 1994). It has also been noted that cases of successful simultaneous economic and political reforms are relatively rare (Intriligator, 1998) and that introducing elections in post-communist countries may have been detrimental economically (Cheung, 1998). Taiwan, South Korea, Chile before the late 1980s, and China to date are usually cited as examples of autocracies that were successful in implementing liberalization and reform.

Sen (1997) criticizes this view and points out, that “we cannot really take the high economic growth of China or South Korea in Asia as ‘proof positive’ that authoritarianism does better in promoting economic growth—any more than we can draw the opposite conclusion on the basis of the fact that Botswana, the fastest-growing African country (and one of the fastest growing countries in the world), has been a oasis of democracy in that unhappy continent.”²² According to Sen (Sen, 1999) the

²¹ Carothers (2002) states that of the nearly 100 countries that are considered to have made a transition from authoritarianism to democracy, only fewer than 20 (10 countries in Eastern Europe; Brazil, Chile, Mexico, and Uruguay in Latin America; Taiwan, the Philippines and South Korea in East Asia; Ghana in Africa) “are clearly en route to becoming successful well-functioning democracies or at least have made some democratic progress and still enjoy a positive dynamics of democratization.”

²² Nonetheless, whether Botswana should be classified as a democracy is questioned by some researchers (Przeworsky et al., 2000) to the extent that the same party has been ruling the country since it gained

comparative studies that are now available suggest that there is no relationship between economic growth and democracy in either direction. Additionally, he calls attention to the fact that all major famines occurred under authoritarian and not under democratic regimes.²³ Olson (1991) argues that autocracies can be predatory, since no one controls the autocrat. He also believes that the populist problem of democracies can be dealt with by introducing constitutions that require supermajorities for certain government actions (Olson, 2000).

A survey of 18 studies (Przeworski and Limongi, 1993) produced mixed results—the only pattern that one can discover in these findings is that most studies published after 1987 find a positive link between democracy and growth, whereas earlier studies, although not different in samples or periods, generally found that authoritarian regimes grew faster. Rodrik (1997) does not find much of a correlation between democracy and economic growth for 1970-89 after he controls for initial income, education, and the quality of governmental institutions. However, he provides evidence that democracies have more predictable long-run growth rates, produce greater stability in economic performance, handle adverse shocks much better than autocracies, and pay higher wages. These findings are very much in line with Przeworski et al. (2000): While there is no substantial difference in long-term growth rates, democracies appear to have a smaller variance in the rates of growth than autocracies (fewer growth miracle stories, but also fewer spectacular failures), a higher share of labor in value added, and a lower share of investment in GDP.

The results of the impact of democracy on growth in the important case of transition economies are no less ambiguous. Fidrmuc (2002) reports a moderately negative initial and direct effect, which is offset by a positive indirect effect (democratization facilitates economic liberalization, which in turn is good for growth). To the contrary, Popov (2000) and Castaniera and Popov (2003) find a negative effect of democratization under the poor rule of law on economic performance and do not find any positive effect of liberalization on growth at least in the first ten years of transition.

Reforms are dynamic processes. Hence, from the point of view of understanding reform, one weakness of these studies is that they focus on *levels* of democracy rather than on *changes* in these levels. Additionally, it is necessary to take into account the context in which the changes occur (i.e. the strength of the rule of law). We drew on Freedom House data for the period from 1972 for over 180 countries to assess the relevance of these hypotheses, that is, to evaluate the impact of changes in democracy on economic and social development in different contexts. It appears that the impact of changes in democracy on economic and social development is different for developed and developing countries, especially when the strength of the rule of law is taken into account: for developing countries with a poor rule of law, greater democratization in 1975-99 is associated with lower growth rates (see Figures 1 and 2).

independence in 1966 and we cannot tell whether it would yield power if defeated at the polls. Nevertheless Freedom House gives Botswana very high scores when evaluating political rights.

²³ Ellman (2000) challenges this point referring to the lack of famines in the authoritarian USSR after 1947 and to the Sudan famine that occurred under the democratic regime in 1985-89. A. Sen himself points out another example—the Irish famine of the 1840s—but he claims that “the English rule over Ireland at that time was, for all practical purposes, a colonial rule” (Sen, 1997).

INSERT FIGURES 1 and 2

Table 1 presents cross-country regression results which show that average growth rates of GDP per capita in 1975-99 are explained by conventional factors (investment, population growth, initial level of GDP per capita), democratization and the rule of law indices.²⁴ The level of democracy in 1972-75 has a positive effect on subsequent (1975-99) economic growth, but democratization (change in the level of democracy) in the 1975-99 period has a negative and statistically significant impact. Likewise, the sign of the coefficient corresponding to the ratio between the rule of law indices and democratization change is positive and statistically significant, suggesting that democratization under a strong rule of law may be beneficial, whereas democratization under a weak rule of law may be detrimental to growth. Transition economies that experienced a deep and prolonged transitional recession in the 1990s are only partly responsible for the results: The transition dummy variable has the predicted sign, but is not very significant and, more importantly, does not undermine the significance of the democratization variable.

Table 1. Factors explaining the average growth rate of GDP per capita in 1975-99 – cross country OLS regression results

| Dependent variable | Average growth rate of GDP per capita in 1975-99 | | | | | |
|--------------------------------|--|---------------|---------------|---------------|--------|--------|
| | 85 | 85 | 85 | 85 | 85 | 85 |
| PPP GDP per capita in 1975 | -.0005 *** | -.0005 *** | -.0005 *** | -.0005 *** | | |
| 2000 investment climate index, | .11*** | .10*** | .11*** | .11*** | .10*** | .10*** |

²⁴ Democratization indices are from Freedom House (<http://www.freedomhouse.org/ratings/index.htm>)—indices of political rights, ranging from 1 to 7 for every year (the absolute level shows the degree of authoritarianism, whereas change, or democratization shows the increase in democracy). The proxy for the rule of law (civil rights/liberalism) is the investment climate index from the International Country Risk Guide (World Bank, 2001). Investors care more about guarantees and predictability of property and contract rights than about democratic/political rights, so liberal authoritarian regimes like Hong Kong (before and after hand over to China) get very high scores.

| | | | | | | |
|--|----------|---------------|----------------|----------------------|--------------|----------------------|
| ICRG | | | | | | |
| Average investment/GDP ratio in 1975-99 | .11*** | .12*** | .10*** | .12*** | .11*** | .12*** |
| Average population growth rate in 1975-99 | -.58*** | -.53*** | -.73*** | -.84*** | -.69*** | -.83*** |
| Level of democracy in 1972-75 (lower values mean more democracy) | | -.19** | | | | |
| Increase in democracy index in 1970-2000 (positive values mean democratization) | | | -.20*** | -.18** | | |
| Ratio of the rule of law (ICRG inv. Index) to democratization in 1975-2000 | | | | | .04** | .04** |
| Transition economies dummy | | | | -1.03 (Tstat =-1.25) | | -1.29 (Tstat =-1.59) |
| Constant | -6.81*** | -5.60*** | -5.90*** | -5.60*** | -6.38*** | -5.91*** |
| Adjusted R ² | 54 | 56 | 57 | 57 | 56 | 57 |

*, **, *** - Significant at 10%, 5% and 1% level respectively.

Sources: World Bank (2001); World Development Institute (WDI, 2001); Freedom House; UNP (2002); Friedman et al (1999)

Przeworski et al.(2000) assess the relationship between democracy and development by analyzing the role of indicators such as population dynamics and life expectancy rather than growth. One relevant finding is that in democracies, controlling for differences in income, birth rates and death rates are lower and life expectancy is higher. Figures 3 and 4, nonetheless, suggest that this a complex issue. The relationship between life expectancy and democratization seems to be positive for developed countries, but not for developing and transition economies.

INSERT FIGURES 3 and 4

Simple cross-country regressions (see Table 2) indicate that after controlling for the initial level of life expectancy in the early 1970s and for the rule of law index in 2000, both the level of democracy and the change in this level in 1970-2000 has a negative impact on life expectancy.²⁵

Table 2. Factors explaining changes in life expectancy in 1975-99 – cross country OLS regression results

²⁵ We also find a strong and robust negative relationship between population growth rates and democratization even after accounting for initial level of income, risk and life expectancy; political instability, communist past and Islam dummy. Birth rates and population growth rates are considerably higher under authoritarian regimes. The latter, however, have a choice of population control policies (like “one child policy” in China); in democracies such policies are viewed as an infringement on human (reproductive) rights and are hardly possible.

| Dependent variable | Increase in life expectancy in 1970-2000 | | | | |
|--|--|---------|----------------------------|-------------------|--------------|
| Number of observations | 124 | 124 | 124 | 124 | 124 |
| 2000 investment climate index, ICRG | .22*** | .17*** | .24*** | .21*** | .20*** |
| Average life expectancy in 1970-75 | -.23*** | -.17*** | -.20*** | -.10(Tst =1.6) | -.12* |
| Level of democracy in 1972-75 (lower values mean more democracy) | | | .52 (Tst =1.61) | .89*** | .78** |
| Increase in democracy index in 1970-2000 (positive values mean democratization) | | | -.59** | -.48* | |
| Ratio of the rule of law (ICRG inv. Index) to democratization in 1975-2000 | | | | | .07* |
| Transition economies dummy | | -3.05** | | -4.34*** | -4.68*** |
| Constant | 5.60 | 5.61* | .11 | -4.39 | -3.98 |
| Adjusted R ² | 14 | 16 | 16 | 20 | 20 |

*, **, *** - Significant at 10%, 5% and 1% level respectively.

Sources: See Table 1

If we assume that the observed negative impact of democratization under the poor rule of law on economic growth and life expectancy is not just a coincidence, it is necessary to investigate the channels through which this occurs. We would like to advance two hypotheses:

- (1) Democratization under poor rule of law leads to the decay of state institutional capacity because it undermines the effectiveness of government regulations (including tax regulations), leads to the expansion of the shadow economy, and limits the growth of government revenues;
- (2) Democratization under poor rule of law makes it difficult to carry out prudent macroeconomic policy (low budget deficits and inflation) and export oriented industrial strategy (undervaluation of the exchange rate and high domestic energy prices preventing inefficient use of energy) because the state becomes a hostage of industrial lobbies and populist groups.

To illustrate the relevance of these hypotheses, Table 3 presents descriptive statistics for “new democracies”–transition and developing countries separately–as compared to all other countries. There certain similarities between new democracies in post-communist and in developing countries. The growth of GDP per capita in 1975-99 is lower than in other countries; the increase in government revenues is less pronounced; the index of government effectiveness is lower; the shadow economy is larger. In addition, new democracies seem to run higher budget deficits (developing countries), and have higher inflation. Only increases in life expectancy in new democracies in developing countries in 1970-2000 are larger (7.6 years) than elsewhere (7.0 years), but as previously noted (Table 2), in multiple regressions (controlling for rule of law and for initial level of life expectancy in the early 1970s) both the level of democracy and the increase in democratization in the last three decades negatively affect life expectancy.

Table 3. Description statistics for new democracies (countries where Freedom House index of political rights improved by at least 1.5 points from 1972-75 to 1999-2002)

| Countries | ALL NEW DEMOCRACIES (62) | TRANSITION COUNTRIES (20) | DEVELOPING COUNTRIES (42) | ALL EXCEPT NEW DEMOCRACIES (148) | ALL COUNTRIES (20) |
|--|--------------------------|---------------------------|---------------------------|----------------------------------|--------------------|
| Improvement in the index of political rights from 1972-75 to 1999-2002 | 3.31 | 3.98 | 3.00 | -0.20 | 0.98 |
| ICRG risk rating, 2000 | 65.1 | 66.0 | 64.6 | 68.9 | 67.4 |
| Ratio of investment climate to increase of democracy index, % | 9.0 | 8.3 | 9.5 | 20.2 | 15.8 |
| PPP GDP per capita in 1999 | 5,510 | 6,900 | 4,885 | 9,588 | 8,059 |
| Increase in life expectancy from 1970-75 to 1995-2000 | 5.7 | 2.0 | 7.6 | 7.0 | 6.6 |
| Annual average growth of GDP per capita in 1975-99 | 0.8 | 0.3 | 0.9 | 1.4 | 1.2 |
| Index of government effectiveness in 2001 | -0.193 | -0.162 | -0.210 | 0.082 | -0.007 |
| Unofficial economy | 35.1 | 28.2 | 40.5 | 21.8 | 28.2 |
| Share of central government revenues in GDP in 1995-99 as a % of 1971-75 | 132 | 56 | 136 | 165 | 154 |
| Average annual budget deficit, 1975-99, % of GDP | -4.49 | -3.26 | -5.01 | -3.94 | -4.13 |
| Average annual inflation, 1975-99, % | 30.3 | 16.6 | 31.1 | 13.2 | 18.8 |

Sources: See Table 1

The rationale for hypotheses (1) and (2) is that weak democracies produce weak governments that are permeable to the pressure of industrial lobbies and populist groups and bureaucracies that are corroded by corruption and crony relationships. Under these circumstances, governments cannot ensure tax compliance, the shadow economy expands, revenues cannot finance public expenditure and it is necessary to resort to inflationary financing. For the same reasons, the authorities are unable to maintain a competitive exchange rate for promoting export growth and have difficulties appropriating rents from natural resource industries, thereby often resorting to price controls for fuel and energy. As a result, growth rates in weak democracies are low and increases in life expectancy are held back by the collapse of preventive healthcare, growing social inequalities, crime and murder rates.²⁶ In the 1990s there were only two regions in the world where life expectancy was decreasing—former communist countries in Eastern Europe and the former Soviet Union, where mortality increased owing to

²⁶ We do not consider income inequalities and crime rates owing to the lack of good quality comparable data. The available evidence suggests though that the Gini coefficient of income distribution is higher in democracies than in autocracies for all GDP per capita groups except for the lowest one (less than \$1000). The gap is the highest for countries with GDP per capita of \$3000 to \$5000: 32-35% for dictatorships and 45-47% for democracies (Przeworski et al., 2000).

stresses of transition, and the southern part of the African continent, where mortality increased because of the inability of the governments to prevent the spread of AIDS. We will now focus on hypothesis (1), which highlights the interactions of institutional factors and democratization and leave the second for Sections IV and V, which address policy issues.

Institutional Change and Transition Countries

The data indicate that the institutional capability of the state is influenced by the rule of law/democratization ratio. Figure 5 shows the relationship between these two variables for the case in which institutional capability is measured by the government effectiveness index. In this case, R^2 is 10%.²⁷ For other institutional capability measures (transparency and accountability, political stability, control of corruption, and quality of regulations) the results are similar.

INSERT FIGURE 5

In line with our previous findings, it seems that the democratization process also has a bearing on institutional capability. The first three columns of Table 4 summarize regression results with the government effectiveness index as the dependent variable. Controlling for GDP per capita and the rule of law indices, democratization that occurred in 1972-99 had a negative impact on the efficiency of the government. This result does not change when controlling for all other measures of institutional capability.²⁸

Table 4. Factors explaining government effectiveness in 2001—cross-country OLS regression results

| Dependent variable | Government effectiveness in 2001 | | | Difference between the government effectiveness and rule of law indices | | |
|---|----------------------------------|---------|--------|---|-----------|------------|
| | 155 | 131 | 154 | 113 | 101 | 87 |
| 1975 GDP per capita | | | | | .00003*** | -.00005*** |
| 1999 GDP per capita | | .00001* | | -.00002** | | |
| 2000 investment climate index, ICRG | | | | .01** | | .007* |
| Rule of law index (WDI, 2001) | .92*** | .83*** | .41*** | | | |
| Transparency and accountability index (WDI, 2001) | | | .09* | | | |
| Political stability index (WDI, 2001) | | | .11** | | | |
| Control of corruption index (WDI, 2001) | | | .25*** | | | |

²⁷ We leave aside Lebanon as the democracy index deteriorated more than anywhere else in this country. Lebanon can be considered an outlier (see Figure 5).

²⁸ The difference between government effectiveness and the rule of law index (measured on the same scale) is of particular interest—when this difference is high, government effectiveness is based not on the rule of law, but on alternative mechanisms (lawless order). Predictably, the last three columns of Table 4 show that this difference is negatively correlated with the democratization of the last three decades.

| | | | | | | |
|--|---------------|--------------|----------------|---------------|---------------|--------------|
| Government effectiveness index (WDI, 2001) | | | | | | |
| Quality of regulations index (WDI, 2001) | | | .18*** | | | |
| Increase in democracy index in 1970-2000 (positive values mean democratization) | -.03** | -.03* | -.06*** | -.04** | -.04** | -.04* |
| Constant | 0.13* | .04 | .28*** | -.63** | .14*** | -.31 |
| Adjusted R ² | 86 | 87 | 90 | 7 | 7 | 10 |

*, **, *** - Significant at 10%, 5%, and 1% level, respectively.

Sources: See Table 1

These findings suggest that assuming the exogeneity of institutions may be particularly misleading in trying to understand the reform process in developing countries. As was noted before, the first version of the WC made such an assumption but it was gradually changed in light of the difficulties former socialist countries experienced to manage institutional change. Given the importance of the experience of transition countries in this regard, we will now analyze that experience looking for evidence about the relationship between institutions and reform.

We center the analysis on state (rather than non-state) institutions and on the factors that help improve or deteriorate this faculty. The institutional strength of the state is defined as the ability of the government to deliver public goods and to enforce its own rules and regulations. The first factor is identified with the government's efficiency to provide public goods (provision of public goods for each monetary unity of spending) and the second with the government's financial strength (the ratio of state revenues (or expenditures) / GDP).

In poor-rule-of-law transition economies the process of democratization was associated with changes in the government's size and efficiency. Most showed a dramatic reduction in the share of government spending in GDP and in the efficiency of state institutions. It is now rather obvious that many weak democracies exceeded the downsizing process and adversely affected economic performance. Beyond long-term considerations about the optimal size of the government, (it is true that in most post-communist countries government revenues and expenditure as a share of GDP are still higher than in countries with comparable GDP per capita) the drastic reduction in spending greatly contributed to the observed institutional collapse. This was specially true regarding the sharp decline in "ordinary government" spending.

Real government expenditures fell by over 50% in a very short period of time in most CIS and South-East Europe countries. Under such circumstances, there was no chance, in practice, to compensate for the decreases in volume by increasing the efficiency of institutions. As a result, the state's ability to enforce contracts and property rights, to fight criminal offences, and to ensure order in general underwent a dramatic reduction. In this sense, the story of the successes and failures of transition is not—as is often suggested—the story of fast liberalizers in Central Europe and procrastinators in the CIS. The major differences in the plot of the post-socialist transformation stories are associated with the preservation of strong institutions in some countries (from Central Europe and Estonia to China, Uzbekistan and Belarus) and the collapse of these

institutions in others. The crux of these stories has more to do with government failure (strength of state institutions) than with market failure (market liberalization).

Prior to transition in former socialist states, government regulations were pervasive and government revenues and expenditure amounted to about 50% of GDP (roughly the same as in European countries). This allowed the state to provide the bulk of public goods and extensive social transfers. Tax revenues as a proportion of GDP decreased markedly in most countries during transition, but there were substantial differences (see Figure 6). Russia, together with Lithuania, Latvia, and several Southeast European and Central Asian states, experienced the greatest reduction while the Central European countries and Estonia managed to check the decline. In Vietnam, in contrast, the share of government revenues in GDP grew by 1.5 times in 1989-93. In the rather successful Chinese experience government revenues as a percentage of GDP also fell from the late 1970s. But the process shows interesting particularities: (1) it was a conscious policy choice rather than a spontaneous process; (2) in the first seven years of transition the decline was barely visible; (3) real government spending increased significantly because of a swift rise in GDP; and (4) the expenditure reduction mostly affected subsidies, defense outlays, and investment financing (the latter was partly replaced by increased bank credits to state enterprises). There were no important cuts in “ordinary government” outlays.

INSERT FIGURE 6

In most CIS states the reduction in government expenditure occurred in the worst possible way. It proceeded without any coherent plan and did not involve the reassessment of government commitments. Instead of shutting down some government programs completely and concentrating limited resources on the remaining ones with an aim to raising their efficiency, the government kept all programs half-alive, half-financed, and barely working. This resulted in the deterioration of key public items such as education, health care, infrastructure, law and order institutions, and fundamental R&D. Virtually all services that the government provided—from collecting custom duties to regulating street traffic—became a symbol of notorious economic inefficiency. This undermined the credibility of the state. Exceptions within CIS prove the rule: Belarus, Uzbekistan, and Turkmenistan. These countries can best be described as illiberal autocracies and are believed to have the strongest state institutions of all CIS states.²⁹ The Ukrainian example, on the other hand, reveals the complexity of pacing the speed of reforms. Ukraine is a procrastinator but did worse than expected due arguably to its poor institutional capabilities (trust in political institutions in Ukraine is markedly lower than in Belarus).

We can distinguish three major patterns of change in the share of government expenditure in GDP, which tend to coincide with the three major archetypes of institutional development or transition “models”. Under strong authoritarian regimes (China), cuts in government expenditure occurred at the expense of defense, subsidies,

²⁹ The decline in government revenues as a percentage of GDP in these countries was less pronounced than elsewhere in CIS (Figure 6).

and budgetary financed investment, while expenditure for “ordinary government” as a percentage of GDP remained largely unchanged (Naughton, 1997); under strong democratic regimes (Poland), budgetary expenditure, including those for “ordinary government,” declined only in the pre-transition period, but increased during transition itself; finally, under weak democratic regimes (Russia), the reduction in the general level of government expenditure led not only to the decline in the financing of defense, investment and subsidies, but to the downsizing of “ordinary government,” which undermined and in many instances even led to the collapse of the institutional capabilities of the state.

While China’s total budgetary expenditures and those for “ordinary government” are much lower than Russia’s and Poland’s, they were sufficient to preserve the functioning institutions since the financing of social security from the government budget is traditionally low. In Russia, however, though expenditure for ordinary government does not seem to be that much lower than in Poland, the pace of their reduction during transition exceeded that of GDP: that is, given the various patterns of GDP dynamics, while Poland’s “ordinary government” financing grew by about one third in real terms in 1989-95/6 (and nearly doubled in China), Russia’s fell by about 70%! The Russian pattern of institutional decay proved to be extremely detrimental to investment and to economic performance, in general.

In market economies, there is generally a positive correlation between the level of taxation, the share of government revenues in GDP, and the size of the shadow economy: If taxes are excessive, economic agents tend to avoid taxation through underground activities, including non-reported barter operations (Gardner, 1988, p.24). In transition economies, the opposite is true: The lower state revenues are, the larger the shadow economy is (see Figure 7)³⁰. In fact, there is a nearly one-to-one crowding-out effect: For every 1 percentage point of the reduction in the share of state revenues in GDP, the share of the shadow economy increases by 1 percentage point. This suggests that the dynamics of the share of government revenues in GDP in transition economies is a quite accurate measure of the ability of the state to enforce rules and regulations³¹.

INSERT FIGURE 7

There was only one group of transition economies where the share of state revenues in GDP remained relatively stable during transition, the Central European countries (see Figure 6). Outside Central Europe only four countries existed where the

³⁰ That is, the Laffer curve is apparently not applicable for macroeconomic comparison of Western countries since higher tax rates result in higher tax revenues despite the increase in shadow economy (tax avoidance). In transition economies, at least in those where institutions are weak, shadow economy growth (whether caused by higher tax rates or not) is so substantial that it more than counterweighs possible increases in revenue collection. Similar results were reported by Friedman, Johnson, Kaufmann, Zoido-Lobaton (1999) for a larger group of 69 countries—higher tax rates were associated with less unofficial activity.

³¹ The decline in government revenues is obviously correlated with performance, but it is not correlated with other explanatory variables, helping to avoid multi-collinearity (see Popov, 2000, for details). Initial conditions, the decline in government revenues, and inflation explain 85% of the variations in the GDP growth rate in 28 transition economies, including China and Vietnam. The correlation coefficient rises further to 92% if other indicators of the institutional capabilities, such as the share of shadow economy, are added, though the number of observations in this case is only 17 because of the lack of data.

share of government revenues in GDP did not fall markedly—Belarus, Estonia, Uzbekistan, and Vietnam. The first three are also the top three performers in the Former Soviet Union (FSU) region, whereas Vietnam’s performance is second only to China’s. It is noteworthy that Belarus and Uzbekistan, commonly perceived as procrastinators, show better results than more advanced reformers. On the other hand, this suggests an alternative explanation of the Estonian success in economic transformation as compared to most CIS states and even to neighboring Baltic states. The usual explanation highlights the progress in liberalization and may be overlooking the impact of strong institutions. Not surprisingly, Campos (1999a) found evidence that government expenditures are positively, not negatively, associated with economic growth in transition economies.

According to EBRD (1999), the quality of governance in the transition economies, as it is evaluated by the companies themselves, is negatively correlated with the state capture index. The relationship seems to be natural: the less corrupt the government, the better the quality of governance. It is also noteworthy that the quality of governance is positively correlated and the state capture index is negatively correlated with the change in the government expenditure/GDP ratio. Countries like Belarus and Uzbekistan fall into the same group with Central European countries and Estonia—with small reductions in the above-mentioned ratio during transition, good quality of governance, little bribery, small shadow economy, and low state capture index (Hellman, Jones, and Kaufmann, 2000)³².

These features of the post-communist transition also seem to be present in other experiences. Specifically, in illiberal democracies the increase in government revenues is less pronounced, the index of government effectiveness is lower, and the shadow economy is larger. The results in Table 5 show the adverse effect of poor-rule-of-law democratization on government revenues and on the ability to limit the expansion of shadow economy. Controlling for the initial level of GDP per capita and the financial strength of the government in 1970-75, it turns out that the largest amount of revenues was collected by (a) countries that were less democratic in 1972-75, and (b) countries that democratized less than the rest in 1970–2000. On the other hand, the shadow economy, controlling for GDP per capita, was larger in countries with poor rule of law and rapid democratization. The rapid rise in the unofficial activities in transition economies was only partially responsible for this effect.

Table 5. Factors explaining increase in government revenues in 1975-99 and the share of shadow economy in GDP in the 1990s—cross country OLS regression results

| Dependent variable | Share of central gov. revenues in GDP in 1995-99 as a % of 1971-75 | | Share of the shadow economy in GDP in the 1990s | | | |
|------------------------|--|----|---|----|--------------------------|----|
| | | | 1 st estimate | | 2 nd estimate | |
| Number of observations | 66 | 56 | 47 | 47 | 47 | 47 |

³² The rule of law/democracy index and the decline in government revenues were complementary rather than substitutes in their influence on the process of institutional decay in some transition countries. These two variables, which are not correlated, improve the goodness of fit when included together in the same regression. The market liberalization index, in contrast, deteriorates the goodness of fit when added to the same equation; it is not statistically significant and has the “wrong” sign (Popov, 2000).

| | | | | | | |
|--|-----------------|-----------------|---------------|------------------|-------------------|---------------|
| PPP GDP per capita in 1975 | .80*** | .80*** | -37.9*** | -36.8*** | -29.5*** | -33.5*** |
| 2000 investment climate index, ICRG | | | | | -.58** | |
| Share of central government revenues in GDP in 1971-75, % | -10.80*** | -13.10*** | | | | |
| Level of democracy in 1972-75 (lower values mean more democracy) | 67.71*** | 73.01*** | | | | |
| Increase in democracy index in 1970-2000 (positive values mean democratization) | -34.08** | | | | 2.00* | |
| Ratio of the rule of law (ICRG inv. Index) to democratization in 1975-2000 | | 7.70** | -.77** | -.94*** | | -.79** |
| Transition economies dummy | | | | -9.5 (Tst =-1.2) | -13.3 (Tst =-1.6) | -14.0* |
| Constant | 63.30 | -218.3* | 171.4*** | 170.8*** | 163.3*** | 159.0*** |
| Adjusted R ² | 64 | 69 | 58 | 59 | 60 | 58 |

*, **, *** - Significant at 10%, 5%, and 1% level, respectively.

Sources: See Table 1

In addition, Figure 8 shows that government effectiveness (subjective indicator of state efficiency based on surveys) is strongly correlated with the share of shadow economy—the objective indicator of the efficiency of state institutions. So illiberal democracies, *ceteris paribus*, over the last three decades had exhibited a poor record in both efficiency of state institutions and financial strength of the government, which predictably translated into the numerous cases of government failures, i.e. the inadequate provision of public goods leading to slower growth.

INSERT FIGURE 8

The results that appear in Table 6 suggest that cuts in government spending and lower efficiency in the enforcement of regulations—as measured by the increase in the share of the shadow economy—have a negative impact on growth. Once we control for the level of development, investment, and population change, the growth rates of GDP per capita are lower in countries with smaller governments and a larger shadow economy. To be sure, we do not think that these results favor big governments. The point here is that in illiberal democracies the ability of the government to provide public services is too weak, weaker than required to maintain a reasonable growth rate. The reasons for this weakness are two-fold—the scarcity of financial resources and the low efficiency of the government apparatus.

Table 6. Impact on investment and growth of government revenues in 1975-99 and the share of shadow economy in GDP in the 1990s – cross country OLS regression results

| Dependent variable | Average investment/GDP ratio in 1975-99 | Average growth rate of GDP per capita in 1975-99 |
|--------------------|---|--|
| | | |

| | | | | | |
|---|---------------|--------------|---------------|-----------------|-----------------|
| Number of observations | 56 | 62 | 62 | 47 | 47 |
| PPP GDP per capita in 1975 | -.001*** | -.0002* | -.0003** | | |
| Log PPP GDP per capita in 1975 | | | | -4.97*** | -4.99*** |
| 2000 investment climate index, ICRG | .32*** | | | .15*** | .16*** |
| Average population growth rate in 1975-99 | | -.93*** | -1.08*** | | |
| Share of central government revenues in GDP in 1971-75, % | .15** | | .05(Tst=1.62) | | |
| Share of central gov. Revenues in GDP in 1995-99 as a % of 1971-75 | .011** | .011* | .014* | | |
| Share of the shadow economy in GDP in the 1990s, 1st estimate | | | | -.044*** | |
| Share of the shadow economy in GDP in the 1990s, 2nd estimate | | | | | -.044*** |
| Transition economies dummy | | | -3.82* | | |
| Constant | -.21 | 2.61** | 1.88 | 9.31*** | 8.49*** |
| Adjusted R ² | 32 | 12 | 16 | 61 | 59 |

*, **, *** - Significant at 10%, 5%, and 1% level, respectively.

Sources: See Table 1

In sum, it seems that the process of democratization is associated with few costs if carried out in *liberal autocracies*, i.e. in countries that have already created a system of protection of civil rights (except for political rights). However, when democratization occurs in *illiberal autocracies*, i.e. in countries that maintain order but have problems enforcing the law, the emergence of *illiberal democracies* results. Their record for ensuring institutional capabilities is very poor, which predictably has a negative impact on output.

The weakening of the state institutional capabilities was especially pronounced in *illiberal democracies*—countries with a poor tradition of the rule of law undergoing rapid democratization. It was observable in the slower-than-elsewhere growth of government revenues and expenditure, as well as in poor enforcement of government regulations (higher shadow economy). It should be recognized that there may be a trade-off between democratization in poor-rule-of-law countries and other developmental goals. Early transition to electoral democracies in countries with a weak rule of law may be detrimental to growth and may inflict high economic and social costs if it undermines the institutional capability of the state and its ability to implement responsible economic policies. The practical implication of this analysis is that, as democracy, participation, and civil society are precious developmental goals in themselves, they should not be compromised by bad implementation.

V. The Asymmetries between Developing and Industrialized Worlds

There is a large body of literature that emerged in recent years that questions the universality of recipes for reform (See, for example, McKinnon, 2002). An usual assumption of this literature is that developed and developing countries are in different positions, which are markedly asymmetric in the context of the Great Divergence. On this basis, this approach states that what may be good for developed countries is not necessarily good for countries that are farther away from the technological frontier and that seek to catch up with developed nations. The argument is that most Western countries 100 years ago did not have either *laissez faire* markets, or today's strict standards of protection of environmental and human rights. By advocating the acceptance of these standards in less wealthy parts of the world, and even threatening developing countries with economic sanctions in case they refuse to accept such standards, the industrialized world might *de facto* undermine the competitiveness of poorer countries and preserve their backwardness, in spite of their good intentions. There are even accusations of a double standard (when the West was industrializing, it did not maintain these standards) and "pulling away the ladder" ("after the West got rich through exploitation of colonies and child labor, it does everything to slow down the growth of the 'other' world"). Many observers have suggested that this double standard helps preserve both protectionism in politically sensitive sectors and barriers to migration flows.

In addition, there are studies that question the fairness of applying the developed countries' pattern of tradeoffs between different development goals (wealth, education, life expectancy, equality, environmental standards, human rights) to less developed countries. Policies that prohibit child labor, for instance, may be an unaffordable luxury for developing countries, where the choice is not between putting a child into school or into a factory, but between allowing children to work or condemn them to starvation. According to this view, the marginal cost of adopting stricter government regulations in such areas as environment and human rights (reproductive rights, working conditions and safety standards, children's and prisoners' rights, and even political rights) in developing countries in terms of deterioration of other developmental indicators (life expectancy) might be prohibitively high.

In this section we provide a brief view of the challenges and conflicts that arise in the context of the asymmetries that exist between the industrial and the developing countries regarding both globalization and domestic reforms. We try to focus on why particular policies/reforms that work in industrialized countries may be less conducive to growth and to achieving other developmental goals in developing economies that are trying to free themselves from the bad side of the Great Divergence.

Protectionism and Industrial Policies

The role of protectionism in the relationships between developing and developed countries has been under close scrutiny for a variety of reasons. One important source of controversy are multilateral trade negotiations. The WTO rules prohibit increased protection of domestic markets, except for special circumstances, and this may be an obstacle to developing countries' growth in certain situations.

On the other hand, there has not been much progress regarding developed countries' protectionism in return, in spite of the fact that industrialized countries' protectionism in some sectors is quite strong. The most striking case is agriculture. This makes it simply impossible for a great number of the farmers from developing countries to compete with the heavily subsidized agricultural products from EU and the US³³. But beyond agricultural issues, the permanent pressure of developing countries to gain market access is consistent with the fact that fast growing countries are usually more involved in international trade – have higher and faster growing trade/GDP ratios (see Figure 9).

INSERT FIGURE 9

However, fast growing and more intensive trading nations are not always and have not always been more open to trade (i.e. showing low tariff and non-tariff barriers) than their less successful competitors and this perhaps explains why the debates on whether free trade or protectionism is more conducive to growth are as old as economic research itself³⁴. Recent empirical studies (Rodriguez and Rodrik, 1999; O'Rourke and Williamson, 2002; O'Rourke and Sinnott, 2002; for a survey, see Williamson, 2002) found that there is no conclusive evidence that free trade is always good for growth: whereas protectionist countries grew more rapidly before the World War I, they exhibited lower than average growth after the World War II. Acemoglu, Aghion and Zilibotti (2002a and 2002b) suggest some hypotheses to account for these stylized facts. They argue that the impact of trade protection on economic performance depends on the distance to the technological frontier. When the productivity gap between the country in question and the most advanced economies is wide, protectionist policies that encourage investment projects consistent with catching-up will likely be more beneficial. These authors actually extend these principles to a number of other policy areas such as promotion of vertical integration and imitation of technology versus indigenous R&D. They state that the larger the distance to the frontier, the greater the returns from vertically integrated companies and from reliance on imported technology.

³³ EU support for agriculture is equivalent to double the combined aid budgets of the European Commission and all 15 member states. Sugar production costs in Europe are among the world's highest, but EU is the second largest world exporter due to subsidies to European producers allowing them to sell sugar at three times the international price (Bailey, Fowler, Watkins, 2002). Overall, according to the World Bank estimate, rich countries spend more than 300 billion a year on agricultural subsidies, which exceeds by a fraction of 6 total official development assistance of rich countries and is roughly equivalent to nearly 2% of PPP GDP of the developing countries.

³⁴ In the 19th century, although detailed statistics does not exist, there are some powerful examples, suggesting that the growth-promoting nature of free trade is not obvious: China after the Opium Wars had to open its economy to international trade completely, but GDP per capita in 1949, when the communists took power, was at the same level as in 1850; growth lost 100 years despite pervasive openness. Taylor (2002), on the other hand, notices that from a nineteenth-century perspective it is hard to argue that tariffs are bad for growth when one considers the impressive performance of such protectionist bastions as the United States in that era.

This debate, in fact, is closely related to the more general one about the role of industrial policy in a developing economy. For many researchers, trade protectionism is no more than just one tool of industrial policy. While industrial policy may be of little use for developed countries, for countries that are catching up appropriate (export-oriented) industrial policy may have high returns. Acemoglu, Aghion and Zilibotti, (2002a) recall that in his famous essay—Economic Backwardness in Historical Perspective—Gerschenkron argued that relatively backward economies, such as 19th century Germany, France, Belgium, and Russia, could rapidly catch up to more advanced economies by introducing “appropriate” economic institutions to encourage investment and technology adoption. The author emphasized the roles of long-term relationships between firms and banks and of large firms and state intervention. Underlying this view is the notion that relatively backward economies can grow rapidly by investing in, and adopting, already existing technologies, or by pursuing an investment-based growth strategy. According to Acemoglu et al., if this assessment is correct, the suitable institutions for such nations are those that encourage investment and technology adoption, even if this comes at the expense of various market rigidities and a relatively less competitive environment. Indeed, as we stated before, the "East Asian Miracle" (WB, 1993) showed, the five countries that managed to transform themselves in the second half of the 20th century from developing into developed economies (Japan and 4 Asian tigers – Hong Kong, Singapore, South Korea, Taiwan) relied heavily on various industrial policy instruments, including protectionism. In addition, on the theoretical side, new analytical tools were recently developed to study industrial policy (see Polterovich, Popov, 2001 for a survey) and the recent advances in the field of political economy have significantly contributed to clarifying the role of rent seeking (corruption, lobbying) and governance aspects associated with the influence of state decisions on economic performance (Grossman, Helpman, 1994; Laffont, 1996; Aghion, Dewatripont, Rey, 1997; Goldberg, Maggi, 1999; Polterovich, 2001). The debate on industrial policy, nonetheless, is by no means settled and the controversies continue.

One conflicting aspect of industrial policy is that it tends, by its very nature, to limit competition, thus making it essentially unfair. The five East Asian Miracle countries limited competition and focused state support on large companies³⁵. But it

³⁵ For example, in Japan 4 major zaibatsu, powerful family-based merchant groups that were transformed into holding companies in the Taisho period (1912-26), controlled 25% of capital in industry, trade, finance and transportation (10 largest zaibatsu – 35% of capital) in 1945. In 1945-50, the American occupation authorities tried to dissolve zaibatsu, transferring their shares to the Holding Company Liquidation Commission that sold them to the new owners with nominal compensation to the former owners, but this policy was basically rolled back with the start of the Korean war that made the US interested in the rehabilitation of the Japanese industry. The major pre-war zaibatsu (Mitsui, Mitsubishi and Sumitoto) reemerged in the form of reorganized business groups, whereas companies that were part of other zaibatsu entered new business groups centering around banks. By the late 1980s 6 major business groups accounted for about 15% of the value of shipments of all non-financial corporations (Lee, 1998) – less than in 1945, but still considerably more than in other large countries.

In South Korea in the 1970s rapid growth went hand in hand with the increase in the share of monopolistic and oligopolistic markets. The share of the 50 largest companies in total manufacturing shipments increased from 34% in 1970 to 38% in 1982, but later dropped rapidly to 30% by 1989. The share of 30 largest chaebols in manufacturing shipments was 32% in 1977, 40% in 1984 and 35% in 1990. Similarly, the share of markets classified as monopolistic went up from 8.7% of total shipments in 1970 to 16.3% in 1977, but then declined to 8.5% by 1989. Lee (1998) believes this temporary increase in concentration ratios can be expected in a small economy at the initial stages of development.

may well be reasonable to pay such a price at a certain stage to accelerate the process of catching up with the advanced economies. Larger, vertically-integrated companies may be in a better position to exploit scale economies, imitate, innovate, and compete in world markets. Acemoglu, Aghion, Zilibotti (2002b) argue that vertical integration allows for the appropriation of rent resulting from investment in production and scale (imitation is automatic, whereas innovation requires investment), although it may also create a managerial overload which discourages innovation. The outsourcing of some production activities mitigates the managerial overload, but creates a holdup problem that could allow the supplier to appropriate part of the rent. Therefore, one can hypothesize that far from the technology frontier, imitation activities are more important, and vertical integration is preferable, while closer to the frontier, the value of innovation increases, encouraging outsourcing. The same logic could be applied to explain horizontal integration and the size of the company in general. The argument would be that larger companies enjoying greater scale economies are more suited for imitation, whereas at the innovation stage there is a tradeoff between costs resulting from managerial overload / lack of specialization and benefits from scale and scope. This naturally raises a set of issues associated with technological policies.

Imitation Versus Innovation and Protection of Intellectual Property

The disparity in technological development is one of the asymmetries between developed and developing countries that gives rise to sharply difficult policy dilemmas and conflicts of interest between countries situated at different stages of the development ladder. Key policy questions are whether there is an optimal strategy to shorten the distance in technological levels; to what extent a developing country should rely upon technology transfer and upon local innovation efforts³⁶; and what the regime of technology transfers should be to allow welfare maximization. As Figure 10 suggests, R&D expenditure as a percentage of GDP appears to increase with the growth of GDP per capita, but there is no apparent link between the level of development and the net transfer of technology.

INSERT FIGURE 10

It is very often taken for granted that intellectual property rights have to be as well protected as possible. The TRIP (trade related intellectual property) rules that resulted from WTO agreements require the protection of patents for no less than 20 years and the protection of copyrights for no less than 50 years. However, the literature has identified several reasons why these rules might be detrimental to growth in developing countries. *First*, stricter protection of intellectual property rights is a double-

³⁶ Acemoglu, Aghion, Zilibotti (2002a) developed a model where the experience of new managers is most important for imitations (investment-based growth), whereas their talents are crucial to innovation-based growth. They model the technological level as given by the level of the pre-existing technology plus the weighted technological change due to imitations/innovations. If the distance to the technological frontier is far, the economy would be better off giving managers long-term contracts that would lead to investment based growth. But, once the economy approaches the technological frontier and innovation yields greater returns than imitation, long-term contracts for managers lead to a development trap, suggesting that at a certain point the life time employment system for managers should be replaced by competitive selection.

edged sword: it stimulates innovations by rewarding the inventor but at the price of inhibiting the dissemination of inventions. Many authors have cast serious doubts upon the usefulness of stricter protection of intellectual property rights (Chang, 2001; Boldrin, Levine, 2002)³⁷. *Second*, even if there is a need to protect intellectual property rights, protection rules could be more lenient in developing countries. There seems to be a consensus among economists and policymakers that the transfer of technology to the poor countries is a highly efficient way to provide assistance. Yet, the TRIP agreements undoubtedly limit the transfer of technology to the South. TRIPS may also affect social development. Copyrights hinder the dissemination of information, knowledge and culture, whereas patents on pharmaceutical products limit the ability of the poor countries to fight diseases and lower mortality rates. It is only in cases of national emergencies, such as the AIDS epidemic in South Africa, that drugs can be purchased/produced with no regard to patent protection. *Third*, in developing countries, there is no clear reason to link intellectual property rights to the trade liberalization agenda as is currently happening within the WTO. The World Intellectual Property Organization (WIPO) was founded at the end of the 19th century, but TRIP agreements were worked out and introduced within the WTO framework. Industrialized countries are in the minority in WIPO and have no leverage on developing countries. In the WTO, instead, the protection of intellectual property rights is linked to trade liberalization and access to industrial countries' markets, which is crucial for developing countries. Developing countries thus find themselves between a rock and a hard place: either access to developed markets with no easy transfer of technology or easy transfer of technology with restricted access to those markets. Since trade liberalization has an intrinsic value for developed and developing countries, to hold it hostage for the protection of intellectual property does not seem to be a rational policy. Indeed, it has been suggested that trade negotiators are "captured" by industry and that intellectual property policies can become overprotective even if trade policy negotiators are equally concerned with all domestic interests (i.e. those of consumers and producers), because intellectual property is the only available tool by which cross-border externalities can be recaptured by the innovating country. To a trade policy negotiator, profit earned abroad is unambiguously a good thing, and the consumers' surplus conferred on foreign consumers does not count at all (Scotchmer, 2003).

Migration

The North and the South may have asymmetric (and to a certain extent conflicting) migration objectives: the former is interested in attracting migrants who are highly endowed with human and other forms of capital, and restrict entry of migrants with limited endowments; the latter would like to stem the flight of human and other forms

³⁷ For example, Sakakibara and Bransletter (2001) studied the 1998 Japanese patent law reforms and did not find any evidence of its positive impact. This and a number of other results "...raise the possibility that strengthened intellectual property rights have led to the socially wasteful accumulation of defensive patent portfolios." (Sakakibara and Bransletter, 2001, p. 99). One can imagine the following alternative regime of the protection of intellectual property rights. All inventions are registered by the state, but enter the public domain not in 20 years, as is the case today, but immediately. The inventor is rewarded by the state – the reward is proportionate to the volume of output created in the first 20 years with the use of patented technology. The reward is paid from the government budget or from the non-budgetary fund to the inventor. Every resident firm can use the technology free of charge, whereas non-residents should pay the state (that holds the patent) for the patent. The inventor in this case is rewarded, but not at the expense of slowing down the dissemination of innovations.

of capital, and would prefer free emigration of unskilled labor as a partial solution to poverty (Schiff, 1997). This is an important issue which has been largely ignored in the debates on market-oriented reform, in spite of the fact that the most important restrictions and barriers that remain in the world economy today concern the movement of people across national borders³⁸. In a neoclassical Heckscher-Ohlin framework the free movement of labor, capital and goods are substitutes in the sense that each of the three can lead to the reduction of wage differentials between the North and the South. There is really no purely theoretical argument which can justify free trade without simultaneously justifying free migration (Hammond, Sempere, 1999). In the words of Dani Rodrik, “if international policy makers were really interested in maximizing worldwide efficiency, they would spend little of their energies on a new trade round or on the international financial architecture. They would all be busy at work liberalizing immigration restrictions” (Rodrik, 2001).

To explain why it is to the benefit of developed countries to support free trade and to oppose free movement of labor at the same time, many researchers point to the gains from immigration of skilled workers (“brain gain”) or to the existence of public goods and redistributive policies in richer countries (Wellisch and Walz, 1998; and Schiff, 1998).

This is not a minor issue from the point of view of high-quality growth. In a dynamic framework, high rates of labor force (population) growth can slow down the growth rate of GDP per capita in a modern growth regime as suggested by the Solow model: at a given savings/investment rate, higher labor force growth requiring more investment in the creation of jobs for the new entrants means less investment in the deepening of the capital/labor ratio. Mass migration of the pre-World War I years from Europe to the New World totally explains the convergence in wages that has occurred: in the absence of mass migration wage gaps between Europe and the New World would have risen from 108% to something like 128%, when in fact they declined to 85% (Williamson, 2002). It may well be that mass emigration from Europe played a crucial role in the transition to the modern growth regime from a Malthusian regime. The latter was characterized by the population growth that was “eating up” all the potential increases in income per capita resulting from technological change (Galor, Weil, 2000). When technological progress accelerated in the 19th century, but the population growth rates still remained high and growing (0.6% in 1820-70) because the demographic transition had not yet occurred, mass migration to North America helped to alleviate

³⁸ Compared to 100 years ago, the world is much less globalized today in terms of the free flow of labor. From 1850 to 1914 migration from Europe to North America (North to North) involved about 60 million people, whereas the South to South migration may have been even larger (Williamson, 2002). This means that annual migration flows in the early 20th century, right before the World War I— about 2 million people a year – were actually no less significant than now in absolute terms and about 4 times more intensive (as a percentage of the population) than now. Suffice it to say that the US population in the 19th century was growing at about 1% a year due to net inflow of migrants (in the 1990s – only 0.3%). The pressure for immigration, however, did not decrease – differences in wage levels in 2000 ranged from \$32 per hour in Germany to 25 cents in India, whereas the progress in the means of transportation and communications obviously reduced the costs of immigration dramatically. That is, the decrease in international migration in the past 100 years is due primarily to the tightening of the immigration control by industrialized countries. An effect of migration that is frequently omitted from the theoretical analysis is remittances of migrants to their home countries. Today the amount of remittances by migrant workers to their countries of origin (\$80 billion, according to the World Bank) exceeds the total official development assistance of the entire Western world (50 billion a year)

pressure on a scarce resource – land, and to avoid diminishing returns (Pomeranz, 2000). The other more traditional explanation of the economic success of the West (criticized in Pomeranz, 2000) also assigns a non-trivial role to emigration: early elimination of serfdom in Europe made free labor more expensive, which, in turn, stimulated the development of labor-saving technologies. Without mass emigration to America and other offshoots, labor in the Old World could have remained less expensive. Today the inability of developing countries to “export” unskilled labor to the West may be keeping them in a demographic trap where all available investment is spent on creating new jobs for the rapidly growing population. Although there seems to be a negative relationship between the growth rates of per capita output and population growth rates, as predicted by the Solow model, some East Asian countries (Hong Kong, Malaysia, Singapore, Thailand) were able to increase output per capita by over 4% annually in 1960-99 with very high population growth rates (2 to 3 % a year). High population growth rates are due to both high rates of natural increase and high net immigration. Thus, international migration does not help to equalize population growth rates by countries – there is no link between rates of natural increase and rates of migration inflows.

In sum, it seems that some degree of international coordination for a higher degree of efficiency in resource allocation could greatly benefit developing countries. In this regard, Bhagwati and Hamada (1974), for example, proposed a tax on emigrants that was levied by the receiving (developed country) party and transmitted in one form or another to the sending (developing) country. This tax cannot be levied by developing countries unilaterally without violating freedom of movement, so there is not much they can do without the cooperation of industrial countries. Nonetheless, the policy priorities of international organizations that deal with migration issues (non-United Nations International Organization for Migration and United Nations International Labour Organization, United Nations High Commissioner for Refugees and United Nations Population Division of the Department of Economic and Social Affairs) do not seem to focus on the issue of liberalizing North-South movement of people or the compensation for brain drain.

Environmental and Other Standards

Developing and developed countries are on different sides of the Environmental Kuznets Curve³⁹ and this is also a source of asymmetric interests and claims at the international level. According to the Kyoto Protocol, quotas for pollution would be allocated to particular countries proportionately to 1990 levels of emission of polluting

³⁹ The Environmental Kuznets Curve (EKC) is an inverted U-shaped relationship between income and CO₂ emissions (Panayotou, Peterson, Sachs, 2000). In early stages of development, capital accumulation results in rising emissions; its contribution to emissions rises as the country industrializes, but falls and becomes negative in the post-industrial age. This may be due to the use of cleaner technologies in all industries in Western countries, but this may also result from the "pollution-haven" effect that asserts that the downward sloping part of the EKC is due to the spinning-off of polluting products to developing countries through trade and foreign investment. Present-day industrial countries were experiencing a more than proportional increase in CO₂ emissions as income was increasing during 1870-1910, just as many developing countries do today (fig.12). In 1910-1950 almost all industrial countries made the environmental transition to less than proportional growth in emissions.

gases, not in proportion to the population. The implicit assumption is that rich countries, owing to their higher productivity, are entitled to produce 50 times more pollutants per capita than, say, African countries, even though rich countries have already produced a disproportionate share of total pollution during last two centuries. Developing countries are still at the stage when income growth, structural change, capital accumulation and trade all contribute to rapidly increasing CO₂ emissions (Panayotou, Peterson, Sachs, 2000). Hence the requirement that emissions be limited to a certain percentage of the level of 1990 imposes a particularly heavy burden on developing countries. Even the requirement to cut emissions per \$1 of GDP to the level of developed countries should be considered unfair because it deprives the developing countries of a chance to follow the same industrialization path that was once followed by the West. Paying a greater share of their GDPs for the environmental cleanup than the industrialized countries once did, less developed countries would have to sacrifice other developmental objectives, such as wealth, health, life expectancy and literacy of population.

Similar arguments can be found in the literature with respect to labor standards (safety, child labor, etc.) and human rights protection in general. No matter how noble the goal, increases in mortality due to the reduction of income resulting from the prohibition to use child labor may be too high a price to pay. A proper evaluation of the trade-offs between the developmental goals should consider the historical origins of the very norms by which such evaluations are made (Kitching, 2001).

V. The International Financial Architecture and the Policy Regime

The participation of developing and developed countries in the globalized monetary and financial systems shows clear asymmetries. According to McKinnon, “Europe aside, the world is on a dollar standard. International trade and capital flows, in Asia, Africa, the Americas and the Australasia are mainly invoiced in dollars, governments hold their official foreign exchange reserves in dollars, and private foreign exchange markets are organized using the dollar as the vehicle currency.... The resulting asymmetry a strong dollar as “definitive” money at the center and a fragile periphery, unbalances the world’s monetary system” (McKinnon, 2002, page 1-2). This unbalanced setting is also characterized by highly incomplete financial markets in emerging countries, frequent speculative attacks against “peripheral” currencies—attacks that sometimes affect countries showing a reasonable policy stance—sudden changes in market sentiment

resulting in “sudden stops,” and financial crises. These features have two important consequences: marked macroeconomic volatility and the inability to take full advantage of international financial flows that could greatly help reducing the Great Divergence.

To be sure, the quality of domestic policies matters a lot in the current situation. But note that national efforts may not be sufficient to ensure sustainable growth in the post-Bretton Woods world, characterized by broad swings in real exchange rates; significant deregulation of trade and financial transactions; and, the greater importance of capital flows, which can be highly volatile (Basu and Taylor, 1999). Under these circumstances, opening the economy has great benefits, but also entails financial and macroeconomic risks. Increased volatility and interdependence have given rise to difficult policy challenges because they simultaneously increased the demand for volatility-reducing policies and severely restrained the domestic authorities’ autonomy.

In this context of macro volatility and asymmetric globalization, reforming countries are facing two key challenges: the implementation of crisis prevention policies that are consistent with sustained growth and ensuring the coherence between national policies and the existing international policy regimes. These challenges are the source of difficult policy dilemmas and call for sizable institution building. Let us examine these problems that are of primary importance to understanding reform.

The International Dimension: Crisis, Governance, and Institutional Building

Good policies are associated with good institutions and, hence, it is a primary task of national polities to build an efficient policy. In an interdependent and asymmetric world, however, national polities are not always able to perform this task alone and the institutions and governance structures that de facto exist at the international level—in which the IFIs have a primary role—are not necessarily in line with national needs. This may be specially so in an uncertain environment. In fact, the succession of crisis episodes from 1995 in emerging countries and the Enron episode in the United States have shown that it is not easy to adapt, implement, and enforce new international rules—and concordant domestic adjustment policies—in response to the changing requirements of the financial globalization process.

In the case of the Korean crisis and the crises that directly followed it, the typical package combined standard FGR macroeconomic adjustments, SGR-inspired measures, and considerable financial support by IFIs. The weight given to FGR and SGR measures and the amount of financing varied according to the circumstances of each crisis. At that time, it was increasingly perceived that packages of this sort would become part and parcel of a “new international financial architecture”. But, of course, these packages were not free of strong critiques, which did not always pointed in the same direction. The positions ranged from those concerned with the recessionary effects of the fiscal and monetary adjustment embedded in the FGR portion of rescue packages to those whose main concern was to mitigate moral hazard in international finance.

Indeed, the debate has had very important practical consequences for developing countries. If the main problems are the market and coordination failures in international capital markets, the situation can be improved by building international institutions that

can improve coordination and cope with such irrational phenomena as contagion⁴⁰. Suitably reformed IFIs are the natural candidates for this role. A corollary of this view is that the building of the “new” architecture should be accelerated. If, instead, the main problems behind volatility and crises stem from dysfunctional domestic policies, the problem should not be tackled at the international, but at the national level. In fact, if the IFIs conducted lender-of-last-resort operations, the situation would only worsen because of the aggravation of the moral hazard problem. This debate is far from settled at the analytical level⁴¹

However, beyond the fascinating analytical facets of this policy problem, the truth is that the most recent changes in the approach to crisis prevention and resolution stemmed from very concrete developments. In this sense, as the Korean turmoil marked the end of the naive approach of the FGR, the Russian crisis destroyed the faith in rescue packages. In Russia, the attempt to stabilize the economy failed because a good part of the financial support was channeled to financing capital flight and to favoring specific stakeholders. Those who had called attention to the role of moral hazard had a strong case. The Argentine crisis in 2001-2 was further interpreted as evidence against rescue packages. Argentina defaulted on its debt obligations in December 2001 after receiving a 30-billion-dollar package (blindaje) from the IMF at the beginning of 2001.

In addition to the lessons from Russia, the change in the IMF authorities was another factor which contributed to favoring the view that moral hazard and domestic policies are the main sources of instability. According to Krueger (2003), the IMF’s primary mission is crisis prevention and only in occasional cases—where crises cannot be prevented—crisis resolution. The Fund should also oversee the adoption of standards and codes, but there is no emphasis on the lender-of-last-resort role. In this way, the discussion about the new architecture was supplanted by the emphasis on “sustainable” domestic policies, the “orderly restructuring” of sovereign debt, and the design of a set of rules to facilitate the resolution of conflict between creditors and debtors (Krueger, 2001, 2002, and 2003). However, the question of how the IMF can act to generate liquidity and facilitate debt restructuring in a crisis situation, and thereby avoid economic collapse in the country involved is still largely unsettled.

Indeed, since the governance structures of the international economy are not well defined and coordination failures between the polities involved are pervasive, it is no wonder that the rules governing capital flows to emerging countries are rather diffuse. Today, it is highly uncertain how much help a crisis country can expect. The policy reaction function of the IMF authorities in the recent Argentine, Uruguayan and Brazilian crises showed marked differences. Uncertainty has been further fed by the lack of advancement in the proposals about the orderly restructuring of debt. The only novelty regarding this was that some countries have introduced collective action clauses in their new debt issues, which seem to be too weak a response to the coordination failure problems posed by debt restructuring and, more generally, to the need for clearer and transparent rules governing international financial transactions. Krueger recognizes that, after a year of vigorous and constructive debates on the need to improve

⁴⁰ On contagion, see Rigobon, 2002.

⁴¹ See, for example, Calvo and Reinhart (2000), UNCTAD (2001), and Rigobon (2002).

arrangements to resolve financial crises, and in particular, to establish the tools to restructure sovereign debt, this remains a “controversial topic” (2003, page 1).⁴²

The economic costs for developing countries of fuzzy governance rules may be sizable to the extent that they are a source of market failures. The literature on international risk-sharing have called attention to the potential welfare gains of consumption smoothing and risk diversification in well-behaved domestic and foreign capital markets (see Obstfeld and Rogoff, 1996). In fact, if markets were perfect, there would be no reason for emerging countries to be more volatile than the rest: consumption fluctuations in developing countries would be perfectly correlated with world consumption. Of course, the studies on volatility in developing countries have conclusively shown that this is by no means the case, and indeed, consumption may even be more volatile than GDP (Rodrik, 1997, Easterly et al., 2000, Fanelli, 2002). Behind excessive volatility lay the facts that: domestic risk-sharing opportunities are far from exhausted; liquidity constraints are pervasive; and, the probability distributions of returns tend to be unstable. When financial-market incompleteness is severe, it is difficult to hedge risk and macroeconomic shocks tend to create severe liquidity constraints and aggravate instability in probability distributions (see Rigobon, 2002). Furthermore, since financial intermediation plays a critical role in resource and risk allocation at the domestic level, the disequilibria on the financial side tend to spill over the whole economy via the effects on credit risk and risk migration; the effects on firms’ balance sheets; and the interactions between solvency, liquidity, national risk, and cyclical fluctuations (Fanelli and Medhora, 2001 and 2002). These facts suggest that better access to instruments to diversify national income risk could significantly improve the functioning of financial markets, thereby facilitating the exploitation of domestic opportunities to improve risk sharing, to manage liquidity, and to smooth consumption fluctuations. We should logically expect important welfare gains were this to occur.

To the extent that the imperfections have both a national and international dimension,⁴³ and are associated with the occurrence of coordination failures, it follows that the attempts to construct institutional coordination mechanisms at the national and international levels should be harmonized. One important service that the IFIs can pay to developing countries is to contribute to developing tools to assess and manage national risks, to manage liquidity, and to facilitate debt restructuring under financial distress. As McKinnon put it, “Most of the world is on a dollar standard with a strong central money where one set of rules is appropriate, and a periphery of more fragile monies where a somewhat different set of rules and modes of operation are necessary” (2002, p.13) and “to recapture the spirit of the 1945 Bretton Woods Agreement today, one must first recognize the mayor institutional changes that have occurred.” This demands a major effort to build institutions and to deepen the political willingness of the polities involved. Given the dispersion of governance structures and the interactions between the trade and financial sides, the efforts should operate at the regional and multilateral levels (Ocampo, 2001) and more linkages should be created, for example,

⁴² She further states: “Bertrand Russell is reported to have said that the impact of education is to raise confusion to a higher level. On that basis of that definition, I think that we can safely say that the debate has been educational!” (2003, page 1)

⁴³ On the “puzzles” that international capital markets pose to economic theory, see Obstfeld and Rogoff (2000).

between the negotiations under the umbrella of the WTO and the discussions in the G-7 and the IMF on monetary and financial issues.

The Domestic Regime and Institutions

According to the IMF's current view, many of the headline crises of the 1990s were "capital account" crises, rather than the older "current account" crises. A capital account crisis takes place when holders of the country's debt lose confidence in the country's future ability to service its debt. Krueger (2003) argues that this explains why emphasis now focuses on the sustainability of macroeconomic policies and factors like debt sustainability and debt management. But, what domestic policy best targets crisis prevention? And, how do we assess debt sustainability? Krueger (2003) states that judgments need to be based, *inter alia*, on: (1) the assessments of the authorities' ability to mobilize and sustain support for adjustment efforts; (2) the likely response of the economy to policies—including real exchange rates, interest rates, external environment, and fiscal/financial implications; (3) the vulnerability to future shocks—including spillovers via balance sheets interlinkages. This raises complex questions involving the domestic policy regime, institutions and the polity, many of which are largely unsettled.

Ample agreement holds that sound fiscal and financial policies are critical to crisis prevention. However, one key unsettled issue questions the kind of exchange rate system that should accompany such policies in the case of a small country in a world of volatile parities of main global currencies. In the immediate post-Asian crisis period a weak consensus existed on the "bipolar" solution (countries should either float or establish a hard peg). Nonetheless, the appeal to the hard peg option considerably diminished because of the fall in Argentina's currency board. Additionally, dollarization has far from solved Ecuador's problems. Indeed, the most important factor was that floating regimes aimed at targeting inflation seemed to perform well in many cases (See Mishkin and Schmidt-Hebbel (2001) for an assessment). This does not mean, however, that a consensus exists about the benefits of adopting a floating regime with inflation targeting. Many well-known analysts (e.g. Williamson, 2001, McKinnon, 2002) are not at all convinced of the virtues of such a solution because it is not clear how effective a tool it is to isolate countries from external turbulence, which is supposedly its major advantage. The Brazilian experience is highly relevant in this regard. Additionally, it seems that many "floaters" show a certain "fear of floating" because of currency mismatches in the financial system (Calvo and Reinhart, 2002) and some researchers, along the line of OCA literature, believe that the formation of more ample monetary arrangements—perhaps in the line with the Chiang Mai Initiative—may constitute a sensible solution (Bayoumi and Mauro, 2001).

Indeed, the "fear of floating" syndrome may be interpreted as a sensible "strategy" for coping with the fact that the linkages between the exchange rate system and financial intermediation are not well known. An inappropriate design of the exchange rate regime may jeopardize a well-regulated and supervised financial system. The stylized facts identified in the literature indicate that the choice of a specific exchange rate regime has consequences on the risks that agents face, the type of financial instruments that will be supplied, the availability of credit, and the structure and conduct of financial institutions⁴⁴. The choice of a floating regime, for example,

⁴⁴ See, for example, Edwards (1999), Frankel (1999) Fanelli and Heymann, (2002)

implies greater volatility and can result in lower levels of financial deepening. The choice of a hard peg, on the other hand, may artificially promote the dollarization of financial instruments. The Argentine experience with the currency board shows that excessive dollarization may exacerbate currency mismatches in the firms' and banks' balance sheets, thereby amplifying systemic risk (Fanelli, 2002).

Any definition of sustainable domestic policies should take into account the association between good policies and good institutions (IMF, 2002a). We have already called attention to the difficulties for institution building in weak, perhaps illiberal, democracies. The interactions between institutions and the macroeconomy generate additional constraints. The debate on dollarization as a cure for a country with bad macroeconomic policies may be useful to illustrate this point. Dollarization was proposed as a solution for the exchange rate system. The argument goes as follows. No exchange rate regime can function well if monetary institutions are not credible. However, the process of building institutions can be difficult, long-lasting, and painful. Under these circumstances, dollarization is a simple short cut: If building institutions is too complicated, a quick way to acquire them is to import ready-to-use institutions. Dollarization, in this sense, is a way to import credible monetary institutions from abroad and is literally a substitute for one of the key functions of the polity (North, 1994). In this way, dollarization becomes the solution to weak institutional building capacity rather than the best response to the problems posed by the choice of an exchange rate regime. But macroeconomic experts normally recognize that dollarization may be too rigid a system and that many developing countries do not pass the test posed by the "optimum currency area" criteria⁴⁵. Hence, the economy may end up with a dysfunctional institution (i.e. an exchange rate regime at odds with its structural features –degree of openness, of price flexibility, etc.) as the "solution" to the regime-choice problem. And, perhaps, this rigid, dysfunctional regime will become a new source of macroeconomic instability that will contribute to further constraining the polity's ability to build the institutions that a sound financial and macroeconomic framework requires. There is little literature analyzing the possibility that a reform may ultimately introduce dysfunctional institutions⁴⁶. For one thing, those advocating these "solutions" to the problem of weak macroeconomic institutions are typically macroeconomists rather than specialists in institutions.

This example raises important points. First, an unstable environment makes it very difficult to coordinate the agent's expectations. That is, one key characteristic of macroeconomic instability is uncertainty and when uncertainty is pervasive, having agents play the "right" equilibrium may be extremely difficult (Fanelli and Heymann, 2002). Multiple equilibria may aggravate the problem of mechanism design, even for a benevolent government that honestly tries to implement the social choice function. Second, there are no well-founded theoretical reasons to discard the possibility of existing, or worse persisting, dysfunctional institutions (Hoff, 2000, Bardhan, 2000).

The models of speculative runs and reputation in monetary policy and the studies on sudden stops and the occurrence of twin crises⁴⁷ highlighted the importance of multiple equilibria. One implication of these models that we want to stress is that, under conditions of multiplicity of equilibria, substantial coordination problems arise

⁴⁵ See International Monetary Fund (1999), Frankel (1999).

⁴⁶ Tommasi (2002) discusses the case of Argentina and the relationship between crises and the polity.

⁴⁷ For a survey, see Pesenti and Tille (2000) or Obstfeld and Rogoff (1996).

and it might be too costly (in terms of information and transaction costs) for the economy to implement a coordination mechanism that can reach the most favorable equilibrium. For example, if the equilibria can be Pareto ranked, the authorities may want to design an arrangement to achieve the best one. However, it may not be possible because the polity is weak due to collective action obstacles (Bardhan, 2000).

The possible existence of multiple equilibria makes it clear that we should sharpen our definition of certain key concepts that we use in the literature on macroeconomic stabilization, such as “sustainability.” Seven years ago, in their survey on structural adjustment, Fischer and Corbo (1995) wrote “an unsustainable policy is one that cannot be maintained for ever” and expressed that the goal of policy reform should be to create the conditions (sound fiscal policies in the first place) for the economy to achieve a sustainable equilibrium (defined in terms of the sustainability of the paths for domestic and external debt). As we have seen, Krueger’s view about our ability to define what sustainability means is much less optimistic (indeed, she considers that this policy definition is not a matter of exact science). This view reflects in part the difficulties posed by multiple equilibria. First, when more than one equilibrium exists, there may be “bad” equilibria (say, low growth, no poverty alleviation) that could be sustained and, consequently, it is reasonable to demand that the reform creates the mechanisms to coordinate the agent’s interactions so as to sustain the best equilibrium. Second, with multiple equilibria some event could trigger an abrupt change in expectations, shifting the equilibrium from one to another, for example, the agent’s fear that a government will fail to serve a big debt. Rogoff and Obstfeld (1996) affirm that this situation would be analogous to a bank run in which withdrawals sparked by depositors’ fears can themselves cause an otherwise viable bank to fail. Of course, a government with strong fundamentals is much less vulnerable. But the point is that the idea of sustainability traditionally used by policy makers may need redefining in a world in which self-fulfilling prophecies and contagion may be present. A policy oriented to ensuring sustainability will surely pay much more attention to the design of coordination mechanisms. There is no a-priori reason to expect, as Feldstein does, that the most effective institutional arrangements to guarantee sustainability can be constructed by each developing country acting alone.

Beyond multiple equilibria, another important constraint to institution building is the path-dependence phenomena. That is, the fact that different institutional agreements coexist in a given situation. Bardhan (2000) signals the persistence of dysfunctional institutions in poor countries, institutional impediments as outcomes of distributive conflict, the collective action problems this conflict exacerbates, and the fact that the state may fail to perform its role as coordinator. Under certain circumstances this role may be critical. According to Hoff (2000), when spillovers are important, they can give rise to a wide range of coordination failures or development traps -for example, low-investment traps, dualism, predation and corruption and inefficient ownership structures (See also, Krugman, 1992). These questions, on the other hand, suggest that there may be subtle linkages between the features of the economic structure and the characteristics of the polity and, thus, of economic institutions. For example, some authors have called attention to the relationship between natural resource abundance and rent seeking (Sachs and Werner, 1995). If this worsens the capability of the state to coordinate in a context of possible development traps and multiple equilibria, natural resource abundance may become an obstacle to development and a source of government failure. Rodrik, in turn, calls attention to the fact that in the case of some small open European

economies, governments have sought to provide a cushion against the risks of exposure to international economic forces and have done so by extending their powers and that "globalization presents this dilemma: it results in increase demands on the state to provide social insurance while reducing the ability of the state to perform that role effectively. Consequently, as globalization proceeds, the social consensus required to maintain domestic markets open to international trade is endangered" (Rodrik, 1997, p. 53).

In sum, if we assume that any policy measure to smooth macroeconomic fluctuations is, by definition, counter-cyclical, it may be useful to distinguish between *short-run* and *structural* counter-cyclical policies. Short-run policies smooth fluctuations, taking the economic structure, the macroeconomic regime, and institutions as given. Structural reforms transform the structure, institutions and the macroeconomic regime to reduce the size and frequency of cyclical movements. The distinction is a natural consequence of a view which stressed the role of market failures, institutional flaws, and some structural features (degree of openness, trade diversification, abundance of natural resources, etc.) as sources of macroeconomic instability and the lack of sustainability. This distinction implies that a program of structural reforms may include counter-cyclical policies, such as measures to complete the market structure and increase its efficiency (to remedy instability-generating market failures); initiatives to restructure institutions and to ensure enforcement of law and regulations, and so on. Note that this view is akin to the optimum currency area approach (Mundell, 1961, McKinnon, 2002). It considers structural features to assess the convenience of a specific exchange rate regime and the scope and effectiveness of macroeconomic policies.

We believe that a research effort focused on the interactions between the structural features of the economy, the macroeconomic/financial regime, and the capability of the polity and the IFIs to build institutions may be useful from both the analytical and the policy making point of view. For example, in the case of Latin America, how can we explain the differences between the Chilean success with reforms, the Argentine failure, and the Brazilian mediocre performance without analyzing the political economy of the reform process in each country and the specifics of the shocks affecting each economy? That is, in order to have a better understanding of the structural reform process, we need to take into account, simultaneously, the comparative advantage of the Chilean political system to make viable the required changes in institutions; the differential degree of portfolio dollarization and financial deepening; the features of the fiscal structure, and the kinds of external and domestic disturbances that affect the economy.

The WC implicitly supposed that IFIs do not behave opportunistically (see Stiglitz, 2000 for a different vision) and that the major obstacle to reform was the lack of political will. In this view, a window of opportunity usually opens when a crisis weakens vested interest groups and obliges political actors to look for newer solutions (Krueger, 1995; World Bank, 1991). In practice, it is frequently assumed that reforms are much easier when a national team is firmly set to reform. However, experience shows that the groups that are accountable for the reform do not act as benevolent dictators of the microeconomic textbook and that IFIs are exposed to lobby pressures, as well.

VI. Conclusions on Reform: Why? What? How Well?

In this section we summarize and classify the main findings of our analysis of the underpinnings of the reforms that have been conceived and applied over the last three decades. The conclusions are classified on the bases of the three main questions that, as we have already mentioned, are key to assessing the reform process. The *Why?* question arises naturally because a reform is an instrument for something else. In principle, it would be irrational to reform something for the sake of reforming it (if it is not broken, why fix it?). This question refers to two points: one, determining the goals of the reform; two, determining the motivations or incentives to reform the economy. The *What?* question refers to the implementation stage and to instrumental issues: What kind of reform best suits the goals? This stage ranges from design to implementation and entails a complex chain of choices and actions, as well as the use of valuable social and economic resources. The *How Well?* question is motivated by the need to evaluate the reform performance. This calls for an appraisal of the specific outcomes, including the assessment of whether some expected results are in fact present, which may be highly controversial because of the problem of observability. On the basis of this assessment, the reformer must decide whether changes in the strategy are necessary. Changes may be purely instrumental adjustments or may imply major changes in goals and strategies including, eventually, the interruption of the reform. In any case, it is usually (at least implicitly) assumed that there is a learning process under way that broadens the knowledge base and will likely improve both policies and institutions.

INSERT FIGURE 11

Figure I summarizes the typical stages and steps of a reform. Of course, the specific purpose of the Figure is to organize our conclusions, and it does not intend to be a description of the stages that must be present in the design and application of each reform. In practice, the goals are not always explicit, the stages and steps to be followed are not consistently designed, and some outcomes are never properly evaluated.

Stage 1. Why Reform?

Figure I shows the two main elements to be considered in answering this question: incentives and goals. Regarding the goals, our analysis revealed that the approach to reform evolved from policy to institutional reform and from focusing on specific goals (trade and financial liberalization) to focusing on the transformation of large segments of the institutional framework that coordinate social interaction. This evolution was closely associated with the occurrence of crises or major international developments. We also noticed that the reasons for establishing the goals were not always explicitly stated and that inconsistencies between goals frequently appeared.

There is a consensus on considering development the ultimate purpose of reform. But there are many well-founded philosophical positions regarding development which are not necessarily compatible. It seems that a sensible strategy for a democratic society to decide on the general direction of reform and to find a set of weights to evaluate the trade-off between different goals is to rely on open public deliberation.

But, of course, public deliberation does not occur in a vacuum; there are constraints posed by both the process of institutional change per se and the polity. We have identified complex interactions between democratization, the rule of law, and reform. This raises the two closely related problems of identifying the incentives of those responsible for enforcing the rules and the determinants of institutional change. Since institutions may be conceived as an equilibrium outcome and there may be multiple equilibria, initial conditions, path dependence, and cultural beliefs are allowed to play a significant role in selecting the equilibrium (Aoki, 2001).

The “intermediate goals” rectangle shows three objectives that we have identified as playing a prominent role in our journey through actual reforms. Sustainable growth (from the macroeconomic and environmental points of view), poverty alleviation, and regime change (from dictatorship/totalitarianism to democracy; from socialism to capitalism). We believe that this set of goals may be used to test the evolution of reform. Of course, this may be considered too narrow or too close to the SA. But, it can also be considered a pragmatic way to check procedural dogmatism. If institutions can be dysfunctional, we should closely monitor the outcomes of the reform. That is, if an efficient outcome is not warranted by any set of rules, then we should use our criterion to judge whether we are on the right track. The role of public opinion cannot be replaced in this task. Consequently, one key function of the polity is to preserve the basic right to free speech. Perhaps, the bulk of the effort to build and improve institutions (both formal and informal ones) should be placed on the construction of the polity. The evidence seems to indicate that ensuring the rule of law is key. Being procedural in the polity and substantive in the economy may be the formulae to avoid savage pragmatism and dogmatism.

The incentives to reform are variegated. In the corresponding rectangle we included the most important: crisis, external pressure, and “endogenous” feedback from elsewhere in the system. It is interesting that “crises” were seen as windows of opportunity. However, there is no definition of what a crisis is in the literature and not much research has been conducted on how crisis affects the institution-building capability in the context of a reform process launched after a sizable crisis. For example, are there path dependency effects associated with the occurrence of a crisis? Is it convenient to start a reform from scratch or is it better to launch a gradual process of reform within a non-crisis scenario? A comparison of the dissimilar experiences of Russia and China or Latin America and India in this regard may be highly relevant. The analysis of both path dependence and discontinuous “jumps” in social and political institutions, as well as the relationship between the two, is still in its infancy. If there are multiple equilibria, it may be too optimistic to assume a priori that a crisis helps to select the best one. We cannot reject just the opposite, that crises may contribute to building dysfunctional institutions or destroy the good ones. The 2001 Argentine crisis may be a case in point. Argentina had made a substantial effort to advance with the FGR and the SGR (Fanelli, 2002). But the crisis resulted in an institutional muddle, a marked deterioration in the institutions supporting markets, and the violation of property rights. Hence, although it is true that crises may help reform, it is also true that crises are costly and that they may destroy institutions. Crises may be the fastest way to reform, but also to dictatorship and populism. The experience with reform suggests that “reform anxiety” may be dangerous, specially if a failed attempt at reforming results in a new

crisis. In this regard, reformers should take into consideration something akin to the environmentalist's precautionary principle.⁴⁸

Much more research is necessary on the causes and consequences of reforms motivated by external pressure and the role of supra national entities in general. Two issues stand out. First, the role of public international agencies and the industrialized countries, which generally have a determinant specific influence on the IFIs. We have identified a series of sharp asymmetries between developing and industrialized countries. These asymmetries introduce a bias in negotiations and governance structures, which do not help to narrow the Great Divergence. One important drawback is the absence of coordination between the negotiations and initiatives in different fora (WTO, IMF, G-7). The second issue concerns the potential contribution of regional agreements for building the new international financial architecture and strengthening reforms. In this regard, the present experience of accession countries should be carefully monitored, as well as south-south attempts like Mercosur or those involving countries with very different development levels, like the Chiang Mai Initiative.

Stage 2. What Reform?

This stage has four main elements. The first is the knowledge base that contains values, analytical models, and information about the economy. Consider the quality of information may vary widely from country to country in the developing world. When reliable information is scarce, people tend to base their actions on opinion and not facts. Beyond the debate on the reform goals in which the role of values is apparent, this is an additional reason why models and values are so highly relevant. Values and models affect the policy-formulation process: The framing of the problem may, no doubt, influence the selection of policy alternatives and recommendations and may even constrain the selection of instruments. For example, it is clear that the discussion about the use of capital controls or dollarization was highly influenced by ideological considerations that went well beyond the technical dimension.

The remaining two elements of this stage have to do with decision taking and implementation. If we were to take an extremely optimistic procedural position, we should assume that the institutions in the polity and the economy would best use the knowledge base to choose the best policies and to implement them in the best way. The final outcome would be the best definition of property rights. But, we have seen that institutions matter in many less encouraging ways and there may be dysfunctional institutions. The dotted line representing the institutional environment and involving the last two rectangles try to highlight this fact.

The elements that we have identified as playing a relevant role in determining the outcome of reform are located inside the rectangles. Implementation problems are key in this regard. We have emphasized the importance of interactions between the

⁴⁸ The principle says: When an activity raises threats of harm to human health or the environment, precautionary measures should be taken even if some cause-and-effect relationships are not fully established scientifically.

- The proponent of an activity, rather than the public, should bear the burden of proof.

- The process of applying the precautionary principle must be open, informed, and democratic, including potentially affected parties. It must also involve an examination of the full range of alternatives, including non-action.

economic structure, initial conditions, volatility, and shocks; the problem of sequencing during transitional periods; the restrictions induced by collective action issues and uncertainty on the process of institutional change; and the linkages between reform, democracy, and the rule of law. All these elements have a bearing on the speed of the path of reform and are related with the old debate on gradualism vs. shock treatment. We have also found that democratization under a poor rule of law may affect the state's institutional capability to implement reforms and the quality of its economic policies. It seems that the costs of democratization may differ under different political regimes and that reforms under illiberal democracies may face severe obstacles because of the difficulties to enforce the law.

Stage 3. How Well Did the Reform Perform?

Both the technical and political evaluation of reforms are necessary and we have already suggested that public deliberation should have the last word on the quality of reform. Our analysis indicates that there is no such a thing as a purely “technical” assessment of reforms to the extent that there is no consensus on specific developmental goals and the trade-offs involved. We do not know much about the process of institutional change and such processes may give rise to hard political dilemmas. For example, we have identified a series of obstacles that reform may face in the context of illiberal democracies

Our analysis revealed that there have been important feed-back channels between the “reform blueprint” and implementation outcomes and that, as a result, the blueprint suffered significant changes. In order to highlight the existence of this learning-by-doing process the Figure points out that there are feedback mechanisms at work. We consider, however, that these feedback mechanisms can be highly improved. Reforming countries have accumulated a sizable stock of knowledge as a result of a learning-through-reform process. This knowledge has not necessarily been properly incorporated into the “lessons” that have been drawn. Much of the research on the results of reforms is now conducted in the ambit of multilateral institutions that have a tendency to focus on common features and to reject the idiosyncratic ones. This was apparent in the discussion of the new architecture and orderly restructuring mechanism. The debate took place mainly in the ambit of the financial institutions in Washington and the issue was approached from the “global” point of view that the IFIs used to adopt according to their mission. The “voice” and analytical efforts of developing countries were basically missing, even though it is important to ensure the consistency between global institutions and practices at the national level. For example, some of the second generation reforms are consistent with certain institutional features of the financial architecture but not with others; to design monetary policies and prudential regulations is critical to knowing whether the IMF will act as lender of last resort. Likewise, the voice of developing countries is necessary to assess more precisely the amount of investment in institutional building activities that will be essential in the context of the SGR.

The methodology of “thinking global” risks the loss of valuable information on the interactions between reform efforts, the economy, stakeholders, and the polity. Detailed knowledge of the functioning and evolution of domestic institutions is often replaced with cross section analyses of dubious relevance. In other instances, the failure of specific policies is attributed to nearsightedness or the lack of political willingness

when the true reason was an incorrect assessment of the political and institutional restrictions and/or the financial risks that structural reforms entail. To evaluate this kind of hypothesis it is necessary to include aspects associated with history, shocks, and the institutional context that tend to be country-specific in the analysis.

In sum, a more profound knowledge of national experiences could greatly help to uncover unknown interdependencies between domestic institutions, the international architecture, and macroeconomic and political stability. A research project oriented to filling the knowledge gaps that we have identified might be useful to society to gain greater ownership of the process of structural reform and to give analytical support to the voice of developing countries. And, indeed, having a voice is very important if we take into account that there is no exit from the global economy.

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Figure 1. Change in democracy (political rights) index, points, and GDP per capita annual average growth rates in 1975-99, %

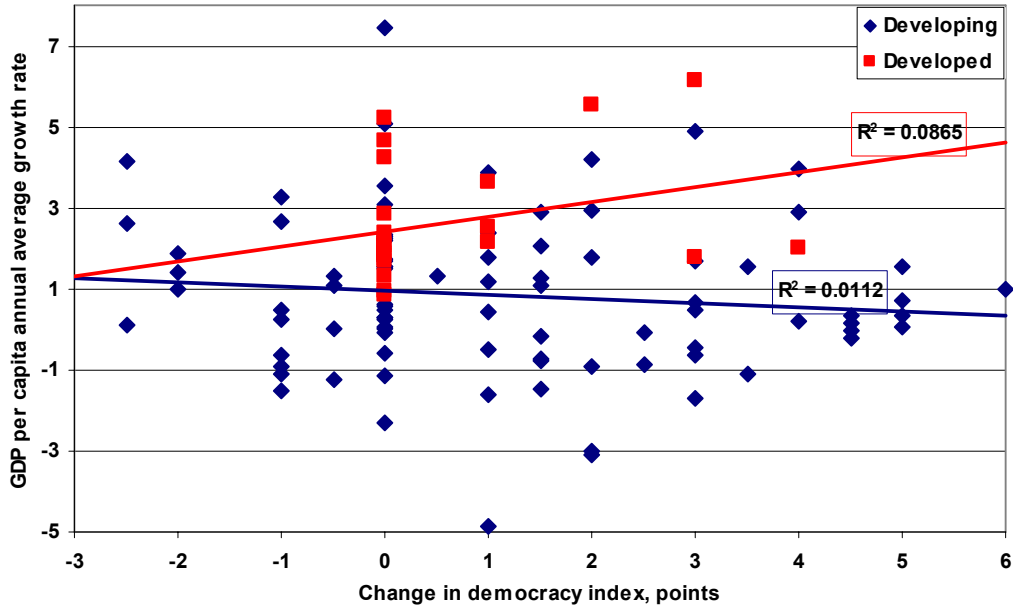


Figure 2. Ratio of investment climate to increase of democracy index, %, and GDP per capita annual average growth rates in 1975-99, %

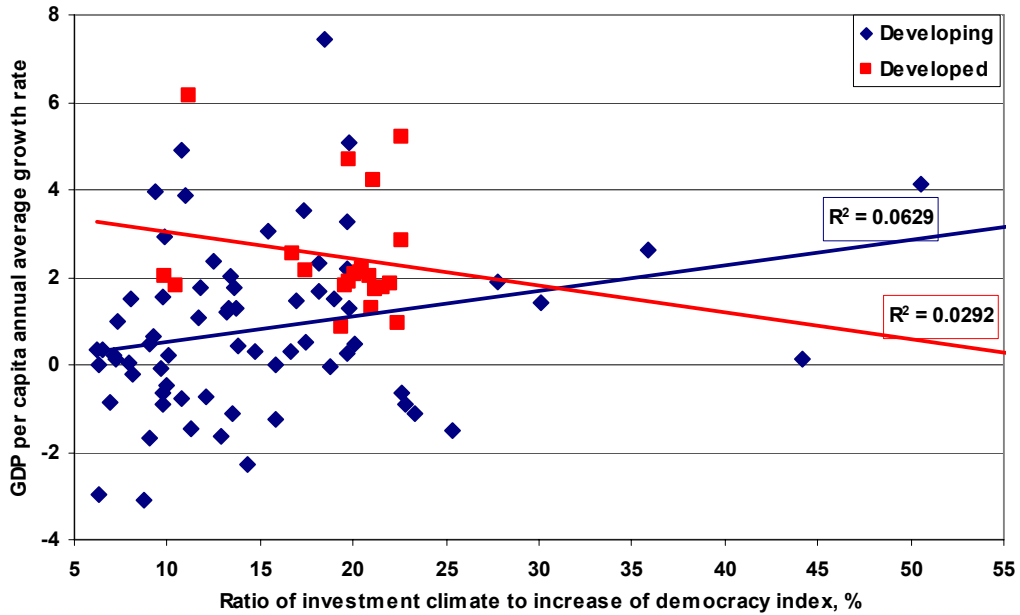


Figure 3. Changes in the life expectancy, years, and in democracy index, points, in 1970-2000

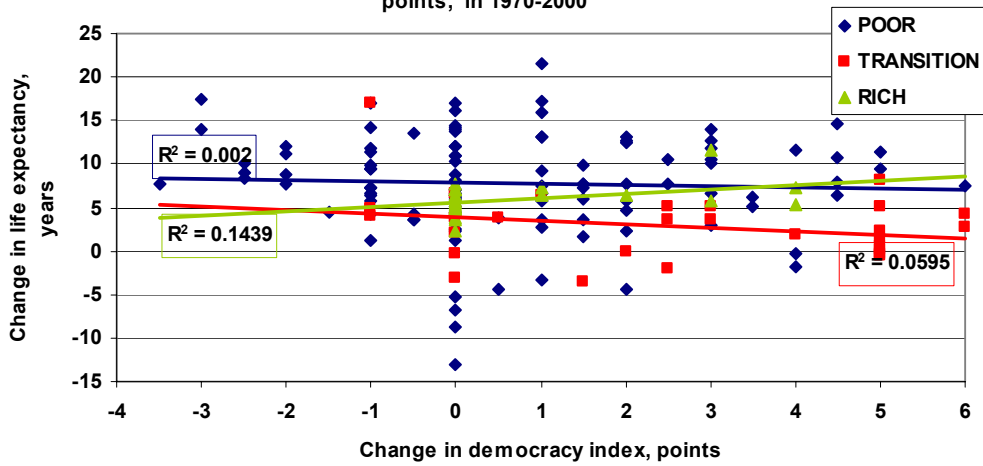


Figure 4. Changes in the life expectancy, years, and the ratio of investment climate to increase of democracy index, %, in 1970-2000

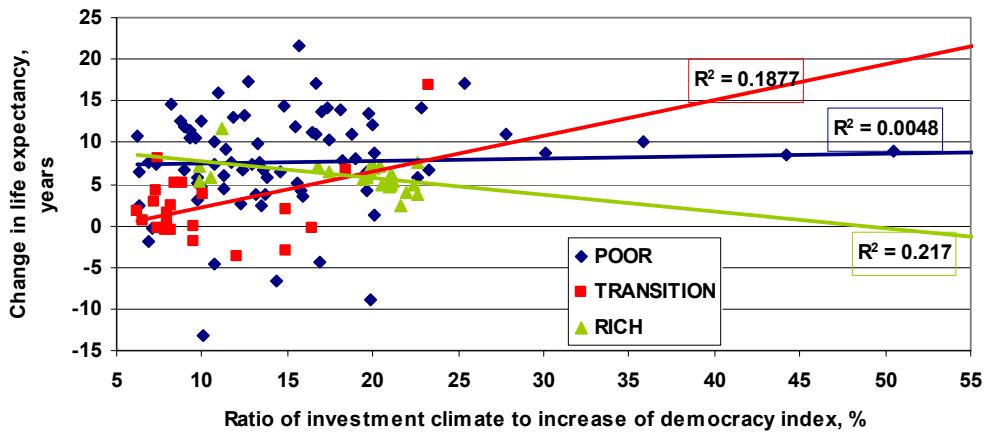


Figure 5. Government effectiveness index (WB, 2001) and the ratio of investment climate to democratization, 1972-99

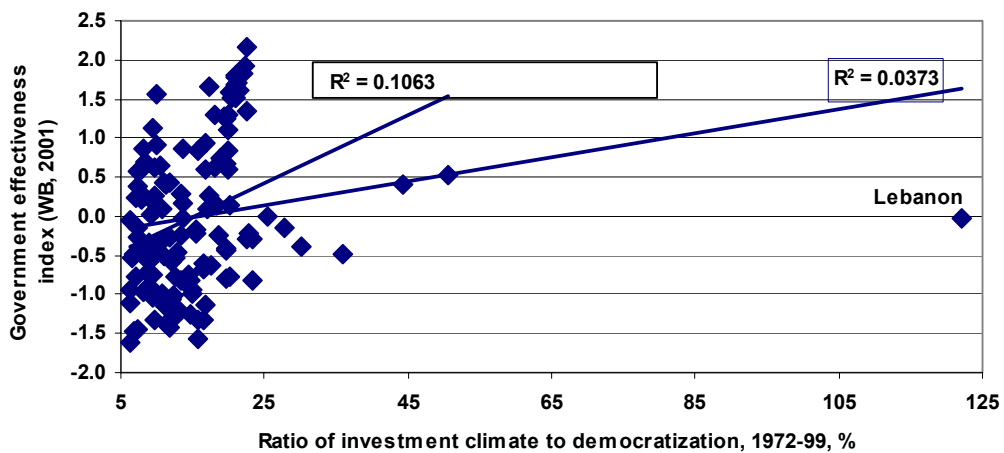
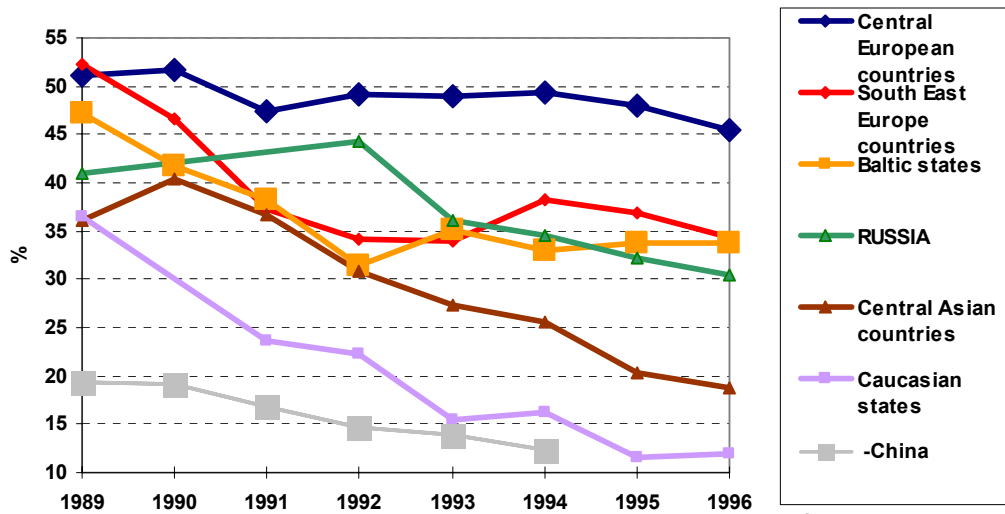
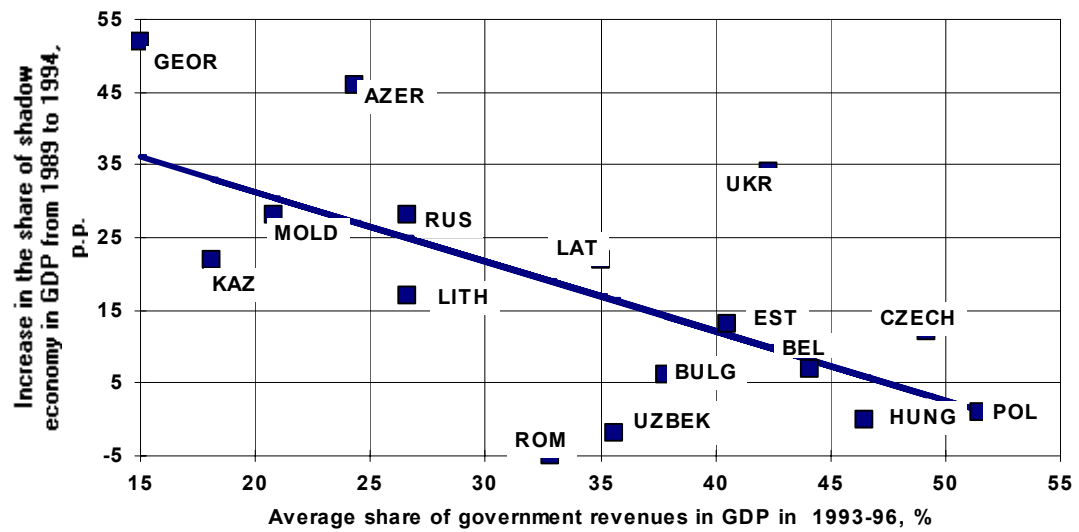


Figure 6. Consolidated government revenues as a % of GDP



Source: (Popov, 2000).

Figure 7. Government revenues and shadow economy, % of GDP, 1989-96



Source: (Popov, 2000).

Figure 8. Index of government effectiveness in 2001 and the share of shadow economy in GDP in the 1990s

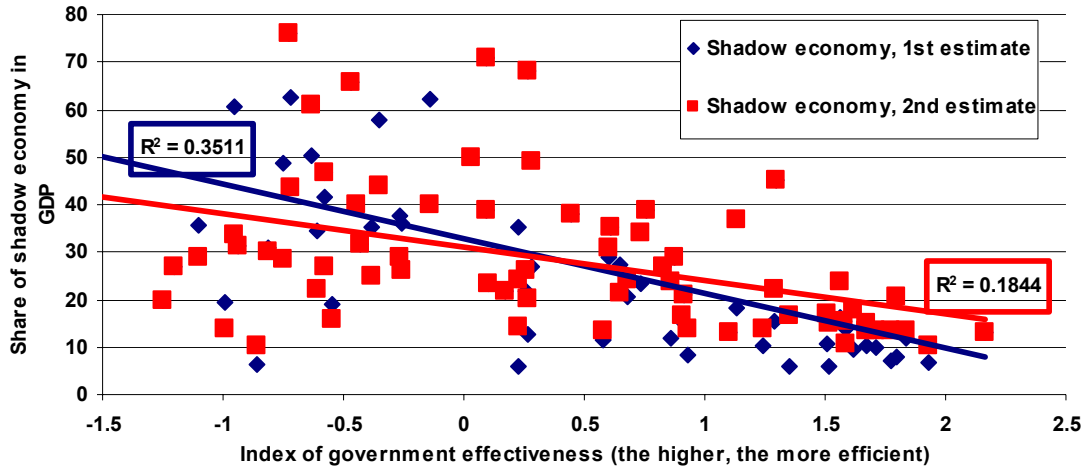


Figure 9. Increase in the ratio of exports to GDP and average annual growth rates of GDP per capita in 1960-99, %

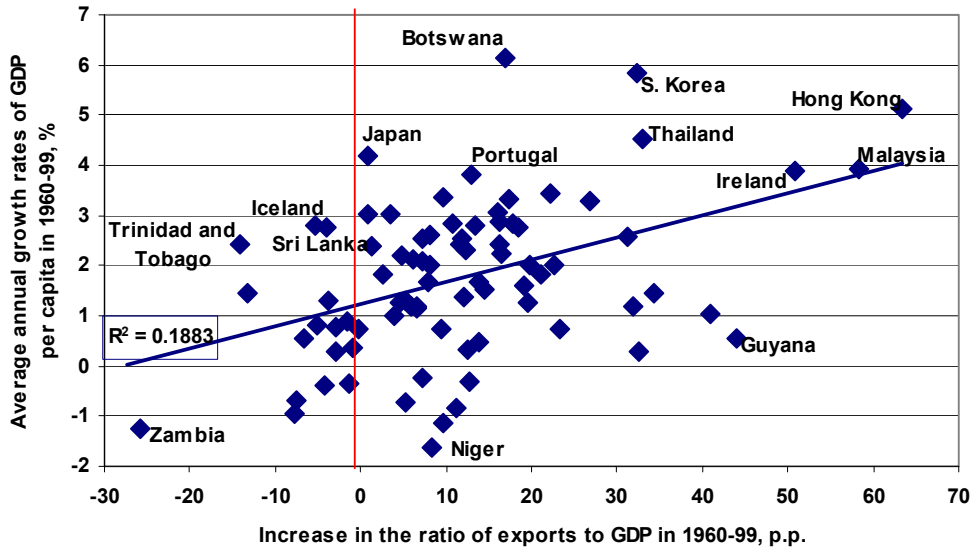


Figure 10. R&D expenditure and net export of technology (receipts of licence fees and royalties minus payments of licence fees and royalties) in 1980-99, % of GDP, and PPP GDP per capita in 1999, \$

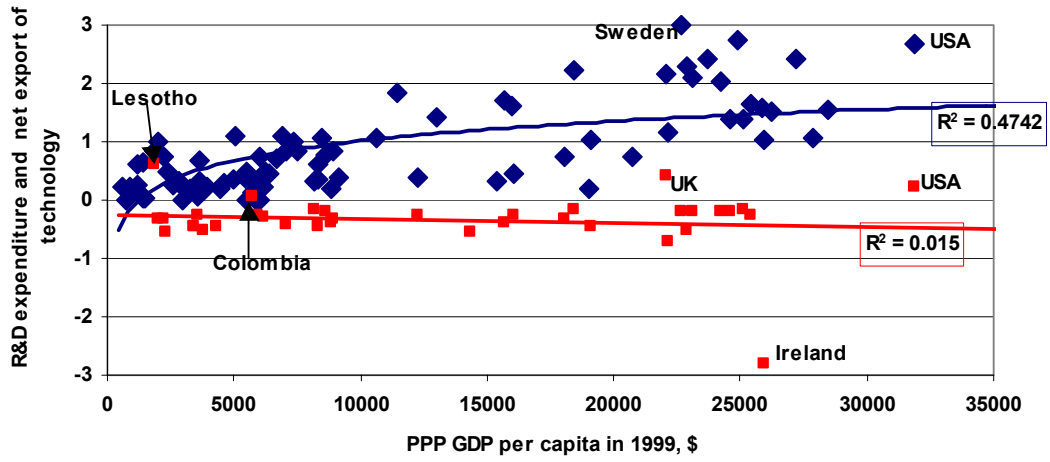
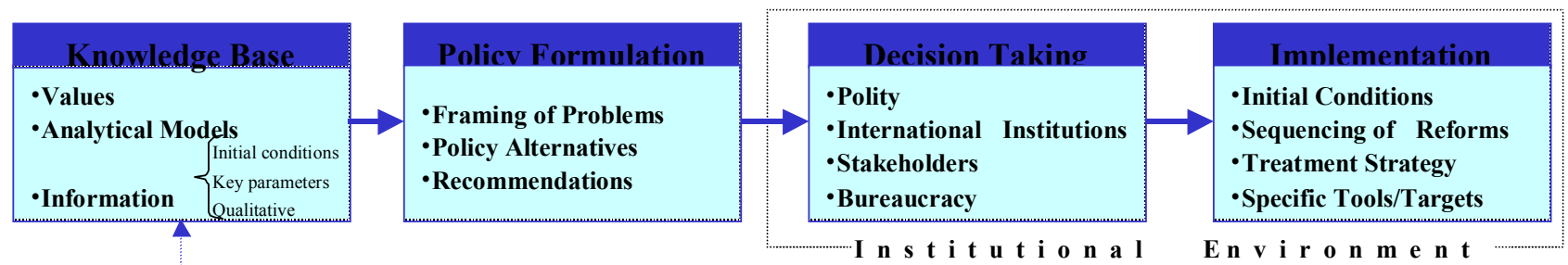


FIGURE 11

STAGE 1. WHY REFORM ?



STAGE 2. WHAT KIND OF REFORM ?



STAGE 3. HOW WELL DID THE REFORM PERFORM ?

