Forum Series on the Role of Institutions in Promoting Economic Growth

Comments on Peter Boettke's "The New Comparative Political Economy"

Prepared by John V.C. Nye
Washington University, St. Louis

Forum 6

The Interaction Thesis: Alternative NIE Perspectives on Development Economics and the Dilemmas of Foreign Aid Policy

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Forum 6 Session on the New Comparative Political Economy

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Peter has done an excellent job of surveying the project he calls the New Comparative Political Economy – which I tend to see as part of the bigger project of the New Institutional Economics. He reiterates the relevant lesson that we have overvalued bloodless theory at the expense of institutions in development.

But he puts too much stress on the Austrian roots of the problem – especially the debate over central planning and socialism vs. market capitalism. Hayek and his views are now mainstream but the focus on the debate over planning does not really give us a good idea of why economists abandoned their core ideas of the market in a discipline which still paid homage to Adam Smith. For that, we had the simultaneous effects of the Keynesian revolution, the mathematization of economic theory, and the demonstration effects of the war. Peter alludes to these but does not really stress how the concern over the Great Depression, and the perception of ordinary people that World War II saved the economy contributed to the interventionist presumptions and increased the willingness to believe in fiscal policy's effectiveness in controlling the business cycle.

But he also leaves out a more important idea that still persists and in my view bears a bigger burden of the mistakes of development policy: the notion that technological change was the primary if not the sole explanatory variable in encouraging long-run growth. If technology could do so much, who needed to worry about institutions? As one of my instructors argued at one time, good institutions may buy a nation an extra five or even ten percent income in the short run, but good technology raised growth rates by one or two percent a year forever. Indeed, it has taken a revolution in our views of economic history, and particularly the widespread assimilation of the claim by North and Thomas that technology did not “explain” modern economic growth, but was itself a manifestation of the phenomenon we think of as modern economic growth.

So now we seem to be waking as if from a bad dream: Naïve Keynesianism is out. The importance of getting the prices right is a priority. Development authorities are concerned with encouraging good institutions. And economists are starting to talk about culture. Overall, no one claims to have a magic bullet for development. But this modesty can lead to confusion, and worse, by arguing that we would often be better off by doing nothing gives no help to those who would do something or worse yet, are required to do so as a political constraint. Unless we can give better guidelines in this regard, the temptation will be to go back to the older nostrums, because something, no matter how flawed, always beats nothing.

It is all well and good to argue that policy advice so be focused on institutions, not planning, and should be situation specific, and not contextualized. But policy makers in the field have long known that advice should be tailored to specific circumstances. But what else is new? That is, in a world where the best modern theory serves to remind us of the impossibility of planning and the contingent nature of advice, what specific guidelines can we provide to redirect the way we think about problems of growth and development?

In my view, the New Institutional Economics, and especially the areas that Peter chooses to call New Comparative Political Economy, can serve as the basis for a different framework in formulating policy guidelines. This comment will outline some ideas that might serve as the beginnings of such a project.

For starters, one cannot get around the uncomfortable fact that most policy advice is centered around macroeconomic theories and ideas and this is a fundamental flaw. We have long known that macroeconomic theory enjoys the least consensus in the economics profession while microeconomics is more generally acknowledged to be of universal applicability. Yet macro policy is most often the focus of all government policy making. This is partly for matters of expediency, and partly a result of the self-interest of government policy makers. Rulers and state bureaucracies want to be seen to have done something and want to focus on things they control, or seem to. Macroeconomics, given the broad nature of aggregates and the easy availability of measurement benchmarks are a natural touchstone for those who want to show immediate improvement, and who know they will be judged on the basis of such measures. Nonetheless, this is almost certainly the worst place to focus on policy advice, precisely because the numbers are so inaccurate or vague, while seeming so tantalizingly precise. Judgments about the appropriate levels of aggregate demand, or having the right industrial mix, or the extent to which growth is "overheating" or below potential, are often pointless, when they are not actively harmful to the needs of long-run improvement.

In general, the best piece of monetary policy advice concerns crisis management. Discussions of policy are not much good in a world that is suffering from hyper inflation. And hyper inflation is just another way of saying that the viability of the entire monetary system is itself under attack. When DeLong and Summers surveyed the role of macroeconomic policies in long run economic performance (1992), the only consistent result seemed to be the importance of low inflation. Hence, we all need to begin from the traditional benchmark of low inflation and stable money provided by independent central authorities.

But after this point, a careful reading of the NIE would now point to a divergence.

Most policy advice places undue emphasis on the role of the budget, in particular, budget-balancing and obtaining appropriate tax revenues. Moreover, many advisers seem preoccupied with obtaining the "correct" interest rates or the "correct" tax rates or the "correct" exchange rates. There is in fact, very little evidence that these matters are of primary importance for the long-run health of a nation. In fact, these issues tend to confuse the health the state government and its apparatus with the health of the economy itself. Governments, especially those paying for advice, are obviously concerned with their fiscal health, but it's not clear why we should be. To take only a trivial case. A "well-run" state with an effective bureaucracy and well-enforced regulations might have taxes so high and regulations so onerous that they choke off real long-term growth and investment. But so long as conditions are stable and there is no deficit, all will seem well. This is especially the case if the possibility of better performance is simply a theoretical supposition with the opportunity costs of excessive government expenditure being unobservable. But macro policy makers are excessively focused on the accounting measures of debt and deficit. This is especially laughable in the case of dysfunctional economies where rules are not well-enforced, and accounting is utterly unreliable. Indeed, the very similarity of macro measures may mislead us into thinking that similar aggregates indicate similar conditions in countries with wildly different institutional structures and where the relevance of measures such as the money supply or the rate of income growth are quite variable as well as unreliable.

This brings me to a central concern of the New Institutional Economics – the role of credibility and the problem of enforceable policies. Several years ago I was in an Eastern European nation speaking to one of the heads of the environmental regulatory agency. I listened patiently to a litany of complaints that there were so many regulations, but that virtually none of them were enforced. The net result was that pollution was essentially unchanged compared to the pre-regulatory regime. When I and some colleagues suggested the possibility of cutting back on the regulations and focusing on the dozen or so core policies that were likely to do the most good and increasing enforcement of them, my hosts replied in shock "Oh no! We couldn't do that! We would be allowing [or be seen to be allowing] too much pollution.

Most states have only rudimentary administrative capacity and much of that is wasted on poor imitations of rules observed in more sophisticated and wealthier economies. Everything from complex progressive taxation to bizarre public utility regulations often stem from copying the principles of first world regulatory agencies. Never mind that the statistics used are dubious, the civil servants corrupt and overworked, and the enforcement capacity haphazard when available. It should be a given that, absent the most important functions of government having to do with the establishment of law and order and protection of basic property rights, most poor countries have no business trying out complicated rules, when the basics are poorly provided. Politics has its own internal rhythm and pressures for many of these rules come from within, but no advisor should add to that burden.

Further, the complex interaction between politics and economics should force us to take seriously the problem of the second best. Though there is an economic literature on this subject it tends to treat constraints on first best policies as exogenously given and focuses on the purely economic effects given certain constraints. This is also misguided. We know enough about rent-seeking and perverse incentives to make endogenous some of the political variables. Given a choice between two reasonable economic policies, we need to learn to promote those that a) can be credibly implemented, b) do not provide large opportunities for increased rent-seeking and c) encourage the development of interest groups that stand to benefit from continued expansion of desirable reforms. Often policies seem to be promoted which a) antagonize the most powerful political constituencies, b) depend upon enforcement from those with little to gain and much to lose from doing so and c) provide opportunities for increased corruption and rent-seeking in the future. This is where context can be usefully integrated with known theoretical principles. Policies that are based on purely theoretical calculations of the first-best that do not take enforcement and measurement costs into account, and that ignore the long-run incentives for rent-seeking have been among the most dangerous outgrowths of the naïve application of theoretical knowledge in the real world.

The current fashion for transparent rules is really driven by this concern for the importance of feedback mechanisms to reward good policies and to punish bad ones. In the end, transparency is not itself the goal. Transparency, is one of the means by which the feedback loop can be improved and political competition can be encouraged in situations where the power to regulate leads to massive rent-seeking and enforcement of new policies is in the hands of corrupt bureaucracies with little interests in putting themselves out of business.

I also think that the very contingent nature of advice, and the difficulty of convincing skeptical nations of the value of important reforms, is one of the reasons for the usefulness of geographically limited experiments and of the various enterprise and free trade zones that are always proposed. The Chinese example is often cited as indicating the value of economic before political reforms. But in my view, China is better seen as demonstrating the value of regional reforms in which early success in Guangdong and Fujian led to increased demands by other cities and regions for some of the reform policies that had worked well in these two provinces. In contrast, even good policies that were seen to be forced on a nation universally run the risk of a backlash against the reform process itself . In an ideal world, hyperrational agents should immediately copy sensible improvements as soon as they become available. In practice, people and politicians want clear cut evidence and often need some equivalent of market pressure to induce them to change. Similarly, no amount of theoretical argument in favor of telecom reform did as much as the simple fact that American long-distance prices fell so rapidly and international companies and their workers used internal networks and private call-back schemes to go around or to undermine existing monopoly arrangements. Indeed, in certain cases, governments have decried the role of technology and trade in forcing them to modify policies on a different timetable. In my view, if market reform has any meaning, this is one of the most basic ways in which globalization and competition can have a powerful effect precisely because it works whether or not the local authorities want it to.

Finally, a note on law. The hardest area for institutional theorists is to deal with the problem of adapting law to local history and circumstance. To begin with, formal law is only as good as the enforcement mechanisms that accompany it. And part of that mechanism is the way in which a law is viewed and the ways in which laws evolve in the local context. Naïve arguments in favor of formalism have led to the spectacle of widespread imitation of Western legal norms without inspiring anything like a homogeneous response to those laws. Here, we will have little in the way of fixed guidelines to direct our efforts. Nonetheless, if we focus on the triumvirate of enforceability, the incentives for promoting or retarding future rent-seeking efforts, and the problem of exacerbating or alleviating the problems of local transactions costs, I believe that we will have a good head start in framing our research.

Above all, we need to remind ourselves: Most of the best work in neo-institutional research depends on two principles

1) Market forces are pervasive, but formal and actually functioning markets are costly in practice and,
2) Economics is all about the benefits of mutually beneficial voluntary transactions, but such exchange depends on some one or some group having the coercive power to create the necessary order. This leads to a contradiction that is never fully resolved but only meliorated and kept under control in the best of circumstances.

Those of us concerned about promoting growth throughout the world should push to make development theory more like medicine, which is conspicuously lacking in good global theory, but which does advance the cause of physical well-being. We need to focus on more effective, albeit tentative recipes for improvement, worked out from a mix of practice and theory, which might coexist uneasily with grand, formal theories that are less than fully integrated into specific practice. But we should let what we know about institutions and political economy guide us in making our experiments and testing our limited prescriptions. And above all we would be wise to heed the advice of doctors who counsel us to "First, do no harm."

De Long, B. and L. Summers, 1992. "Macroeconomic policy and long-run growth." *Federal Reserve Bank of Kansas City: Economic Review* 77, 5-31.