

CDDRL

WORKING PAPERS

Avoid Hubris and Other Lessons for Reformers

John McMillan¹

Center on Democracy, Development, and the Rule of Law
Stanford Institute for International Studies



Number 2
12 June 2004

This working paper was produced as part of CDDRL's ongoing programming on economic and political development in transitional states. Additional working papers appear on CDDRL's website:
<http://cddrl.stanford.edu>.

¹ I thank Peter Henry and Romain Wacziarg for comments.

Center on Democracy, Development,
and the Rule of Law
Stanford Institute for International Studies
Stanford University
Encina Hall
Stanford, CA 94305
Phone: 650-724-7197
Fax: 650-724-2996
<http://cddrl.stanford.edu/>

About the Center on Democracy, Development and the Rule of Law (CDDRL)

CDDRL was founded by a generous grant from the Bill and Flora Hewlett Foundation in October in 2002 as part of the Stanford Institute for International Studies at Stanford University. The Center supports analytic studies, policy relevant research, training and outreach activities to assist developing countries in the design and implementation of policies to foster growth, democracy, and the rule of law.

About the Author

John McMillan is coordinator of the Program on Economic Performance at CDDRL; the Jonathan B. Lovelace Professor of Economics; and a senior fellow at the Stanford Institute for Economic Policy Research. His research focuses on economic reform, mechanism design, cross-country comparisons of market institutions, and entrepreneurship in developing and transition economies. Professor McMillan is on the editorial board of several academic journals, including the *Journal of Economic Literature*; *Contemporary Economic Policy*; the *Journal of the Japanese and International Economies*; *Contemporary Economic Policy*; and *Risk, Decision and Policy*.

The past two decades have seen a worldwide shift to markets. Globalization has opened domestic markets to international competition. The ex-communist countries have converted themselves, to varying degrees, into market economies. In the low-income countries, privatization has shrunk state production. The results of this expansion of markets have been mixed. What lessons does the experience with reform, in both ex-communist and developing countries, hold for future developing-country reformers?

The Asian financial crisis of 1997-98 caused severe hardship to millions of ordinary Indonesians, Koreans, and Thais. Russia's 1991 market reforms were followed by a decade of negative growth. In Latin America, privatization was often so corrupt that in polls a clear majority now say it was not beneficial.

The good news, however, outweighs the bad. India and China are growing. The average Chinese is three times as well off now as in 1980; the average Indian is twice as well off. It is impossible to exaggerate the consequences of rapid growth in two very poor, very large countries.

The good news goes beyond China and India. Trade opening and privatization in various developing and ex-communist countries, from Uganda to the Czech Republic, have mostly brought their intended benefits. However, the improvements, while in net positive, have been spotty: often slow in coming and relatively small. The gains from market reform are inconspicuous; you have to look hard at the data to see them (as the studies reviewed below do).

One of the lessons for reformers is that the efficacy of any one policy depends on other policies, in ways that are often unforeseeable. The chief lesson is: Avoid hubris.

Reform gains

Studies of countries lowering their trade barriers have found that, while the consequences have varied from country to country, trade reform has usually improved economic performance and consumers have benefited from the lower prices. A substantial trade opening boosts economic growth, on average, by an estimated 1.5 percentage points (Wacziarg and Welch, 2003). The measured benefits from trade opening are significant, but not huge.

Developing countries that have opened themselves to investment from overseas have similarly benefited. In countries that began to allow foreigners to hold shares in domestic firms (a diverse group, including Indonesia, Brazil, and Nigeria), investment rose. Growth averaged 1.1 percentage points higher after liberalization than before (Henry, 2003).

With privatization the story is similar: genuine but unspectacular improvements. After being privatized, the typical firm raises its labor productivity, increases its investment, and lowers its prices. Studies of 211 firms in more than 50 countries, comparing firm performance for the three years before privatization with the three years after (Megginson and Netter, 2001), find that investment as a percentage of sales rose an average of 5 percentage points. Because state firms produce only a fraction of GDP, such improvements translate into a small gain in aggregate growth.

Is tackling corruption, by improving the rule of law, the solution? The cross-country data show that corruption significantly slows growth (Mauro, 1995). If India were to cut its corruption level to, say, Italy's, then, according to these regressions, its growth would rise 1 percentage point. As with any other single policy, cracking down on corruption helps but is no panacea.

The sum of these estimated growth effects of trade opening, financial liberalization, privatization, and corruption lowering is a little less than 4 percentage points. This total should be taken with a grain of salt. The estimates are rough. Also, adding them may overestimate their combined effect (some countries liberalized trade and investment simultaneously, so there may be some double counting) or underestimate it (as discussed below, the whole of reforms may be more than the sum of their parts). Putting the caveats aside, how much difference would such an increase in growth make?

Boosting the rate of growth from, say, 3 percent to 7 percent would mean that it would take 10 years for national income to double, instead of 23 years. (To calculate how long it takes for income to double, divide the growth rate into 69.) If an African country with zero growth were to liberalize and attain 4 percent growth, people's standard of living, instead of stagnating, would double every 17 years. Africans would steadily become less poor, but would still be very poor.

In the United States, per capita income is \$35,000. In Tanzania it is \$550. The gap in living standards is 64 to one. The measured gains from trade opening, privatization, and anticorruption policies do not go far in shrinking that gap. Any solution to global poverty will entail transforming the poor countries' economies. What have we learned from two decades of reform experience?

Iraq suggests we may not have learned much at all. In 2003, the American-run Coalition Provisional Authority announced big-bang reforms for Iraq. The intention, the *Economist* said (September 27, 2003), was to "abruptly transform its economy into a virtual free trade zone." The reforms, gushed the *Economist's* reporter, were "bright economic news," which promised to "yank Iraq back into the global economy in record time." Unfortunately, even given an end to the violence, they probably wouldn't. That in 2003 the American officials advising Iraq would recommend big-bang reforms demonstrates, I contend, the remarkable longevity of bad economics.

Reform is hard to do because we cannot predict its effects. The big-bang approach presumes we know where we are going and how to get there. We may know where we should be headed, but there is much we do not know about how to get there. No recipe for success has yet been written. Acknowledging our ignorance means moving step by step rather than betting everything on a comprehensive blueprint (McMillan and Naughton, 1992). The whole point of the market economy, after all, is that it handles, better than any more centralized alternative, the unforeseen and the unforeseeable. If we could plan the reforms, we could have planned the economy.

System renovation

Why is market-building difficult? Reform means transforming the entire economic system. The various parts of a reform package reinforce each other. A pair of reforms may be complementary, meaning that unless one is already in place, the other is ineffective. A potentially worthwhile reform could even be harmful if its complementary reforms are missing.

Trade liberalization is a case in point. For some countries, trade opening did not bring its intended benefits. In a sample of 24 countries that substantially liberalized their trade (Wacziarg and Welch, 2003), about half achieved faster growth following

liberalization. For example, Chile grew 2.8 percentage points faster and Uganda grew 2.2 percentage points faster. A quarter obtained no improvement in growth and a quarter actually grew more slowly than before. For example, the Philippines grew at the same rate as before and Mexico grew 2.2 percentage points slower.

The effects of trade reforms have varied widely from country to country. There is a lot of variation around the average 1.5 percent boost to growth cited earlier. It is widely agreed among those who have studied reform that opening the economy to trade is good policy—but only if it is ready for it.

Trade opening might not be beneficial if the labor market is distorted. The gains from trade reform come, in principle, via reallocating labor. Workers move within a given industry, from the less efficient firms to the more efficient ones, and across industries, from those that had been protected into those in which the nation has a comparative advantage. After Brazil lowered its trade barriers in the early 1990s, for example, firms revamped themselves. However, most of the efficiency gains came from workers moving within their own industry. Contrary to the trade-theory textbooks, there was little movement of workers across industries. Moreover, many of those thrown out of work were not rehired but became chronically unemployed, scraping by in the informal sector. The workers bore high transitional costs (Muendler, 2003). In other countries the pattern was similar. A study of 25 countries opening their trade found little structural change had occurred (Wacziarg and Wallack, 2004). The transition from declining industries into the industries of the future is held back if the labor market is not up to the task. Labor-market reforms complement trade reforms.

Similarly, whether privatizing a state-owned firm improves its performance depends on its economic environment. Ownership incentives are not enough by themselves to induce large firms to be run efficiently. Also needed are the oversights that come from well-functioning (and well-regulated) financial markets. As Enron illustrates, these oversights sometimes fail even where financial markets are sophisticated. Enron-type problems are pervasive where financial markets are underdeveloped. After Mexico's banks were privatized, for example, their managers engaged in "related lending," making loans to themselves on generous terms. The Russian natural-gas giant Gazprom has a market value far below its assets, reflecting stockholders' skepticism after

the managers sold the firm's gas deposits for a fraction of the billions they were worth. While asset stripping is not universal—the data show that privatization has usually improved firm performance—it can occur if privatization is pursued in isolation of other reforms. Financial-market oversights complement privatization.

Wide-ranging reform is what is needed—but it is hard to do. When New Zealand radically deregulated in the mid-1980s—slashing trade barriers, removing agricultural price supports, flattening taxes, trimming financial-market regulation, corporatizing and privatizing state-owned firms—it suffered a major recession, with negative growth and high unemployment. It took more than a decade for any benefits to show. The setting for the reforms was favorable. An industrialized country, New Zealand had started with a full set of market-supporting institutions like laws of contract, and its labor and financial markets had been operating reasonably effectively. The reform process can be expected to be more painful in a country like Mexico or Turkey, where the legal system is creaky and the labor and financial markets suffer from high transaction costs, and even more painful in a country like Tanzania or Bangladesh, where market mechanisms are stunted.

Social engineering

The need for a package of reforms could be a reason, on the face of it, for doing everything at once. But here is the rub. It is hard to predict how the pieces of the market system fit together. Some systemic interactions may be complex and indirect, and so we may not even be able to anticipate their existence. Others are straightforward, like trade reform plus the labor market or privatization plus the equity market, but we have little data on their magnitude.

Within each individual market, also, there are systemic complexities. Building a smoothly functioning labor or financial market is a far harder task, and more time-consuming, than freeing up trade or privatizing firms. Imagine being charged with creating an equity market in a country that lacks one, like Burma. The equity market relies on trust: investors hand over their money to managers with little direct assurance that it will not be misused. To sustain that trust, it is necessary to build a mix of private-sector and government-based mechanisms (Black, 2000). The firms that oversee the market—accountants, investment banks, law firms—must have, and want to keep, a

reputation for trustworthiness. Such a reputation is developed only over time. Self-regulating organizations—the stock exchange, with its rules on financial reporting and its sanction of delisting, and various voluntary industry associations—help keep the players honest. A vigorous business press is needed to scrutinize companies’ dealings. To prevent managers from expropriating the investors’ funds, the government must write laws and train judges. To ensure investors receive accurate information, the government must set up a regulator like the U.S. Securities and Exchange Commission to bolster the courts. The workability of each of these equity-market mechanisms is contingent, in ways we cannot fully anticipate, on the presence of the others.

Half a century ago, in *The Open Society and Its Enemies*, Karl Popper contrasted two modes of reform. *Utopian social engineering*, with a grand blueprint for society, “pursues its aim consciously and consistently” and “determines its means according to this end.” *Piecemeal social engineering*, by contrast, involves tinkering with parts of the system, with no overall plan. Whereas piecemeal reform entails “searching for, and fighting against, the greatest and most urgent evils of society,” utopian reform entails “searching for, and fighting for, its greatest ultimate good.”

The utopian approach is “convincing and attractive,” with its appeal to rational thought. However, Popper argued it was folly. The utopian approach “demands a strong centralized rule of a few.” By contrast, the piecemeal approach can succeed. Because it acknowledges that “perfection, if at all attainable, is far distant,” the piecemeal approach is “the only method of improving matters which has so far been really successful, at any time, and in any place” (Popper, 1971, pp. 157-159).

Popper’s argument that piecemeal methods work better than utopian, already tested and affirmed by (utopian) communist central planning, was further tested by the move away from communism. China tried piecemeal reform, Russia utopian.

Big-bang reform was characterized by its architect Jeffrey Sachs as “a rapid, comprehensive, and far-reaching program of reforms to implement ‘normal’ capitalism.” Sach’s characterization fits Popper’s definition of utopian social engineering, in being “comprehensive” and in having a stated endpoint, “*normal* capitalism.” Russia’s income dropped after reform. These numbers overestimate the drop in living standards, as the unmeasured underground economy grew, but after correcting for this the growth is still

negative. If retail sales and electricity consumption are used as indicators of economic activity, Russia's 1999 economy was operating at about 80 percent of its 1990 level (Shleifer and Treisman, 2003). The consequences of Russian big-bang reform corroborated Popper's dismissal of grandiose schemes.

China's reforms, bringing spectacular income growth of around 8 percent per capita for 30 years, were piecemeal. Each reform was tried out on a small scale and expanded if it worked. The endpoint was undefined. In Deng Xiaoping's folksy formulation, China was "crossing the river by feeling each stone." When pressed on where China was headed, its leaders said they wanted a "social market economy with Chinese characteristics" —a phrase that is empty of meaning, and presumably intentionally so.

Where to start?

The modest (or piecemeal) reform prescription is to start with something that seems feasible and sensible. In 1980s China, for example, early success came in agriculture. When the collective farms were abolished and replaced with individual plots, China's food supply doubled. The collectives were a hopelessly inept way to organize farming, as the farmers themselves were well aware, so easy gains were to be had.

A willingness to experiment with novel incentive devices and new organizational forms is sometimes part of successful reform (McMillan, 2002). China's other early success was in the creation of village enterprises: small manufacturing firms owned and run by village governments. The reformers failed to anticipate the village enterprises' rapid growth, which "took us by surprise completely," as Deng later said. With hindsight, though, these firms' success is explicable: they found a ready sale for their products by filling empty market niches, they created jobs; they obtained finance, otherwise unobtainable, via the villages' powers of taxation, and they were disciplined by the intense product-market competition among themselves that quickly developed.

In reform, one size doesn't fit all. What works varies with the country's initial conditions. That village-owned firms were the main source of China's first decade of growth demonstrates that the specifics of time and place matter. Village-owned firms are unsuited to present-day China, and are unlikely to be the solution in another country.

Nonstandard policies sometimes work, at least for a while. Much as India and China have benefited from connecting themselves to the global economy, they are not free traders. They have grown despite keeping sizeable trade barriers. (Through the 1990s, China maintained bureaucratic controls over imports of goods and currency, while India's tariffs averaged 40 percent and nontariff barriers were widespread.) India and China are counterexamples to the proposition that full trade opening is necessary for economic growth. They do not represent an argument against open trade—the theoretical and empirical case for it is well substantiated—but they do warn against seeing free trade as a universal remedy. The case for open trade is not helped by overselling.

The honest approach to economic reform is to be deliberately experimental. To claim we can do something more premeditated than trial and error is to exaggerate our knowledge of reform processes. *Avoid hubris.*

John McMillan is the Jonathan B. Lovelace Professor of Economics at Stanford University's Graduate School of Business in California.

References

- Black, Bernard, "The Legal and Institutional Preconditions for Strong Stock Markets," *UCLA Law Review* 48, 2000, 781-855
- Henry, Peter Blair, "Capital Account Liberalization, the Cost of Capital, and Economic Growth," *American Economic Review*, 93, 2003, 91-96
- Mauro, Paolo, "Corruption and Growth," *Quarterly Journal of Economics* 110, 1995, 681-712
- McMillan, John, *Reinventing the Bazaar: A Natural History of Markets*, New York, Norton, 2002
- McMillan, John, and Naughton, Barry, "How to Reform a Planned Economy," *Oxford Review of Economic Policy* 8, 1992, 130-143
- Meggison, William L., and Netter, Jeffry M., "From State to Market," *Journal of Economic Literature* 39, 2001, 321-389
- Muendler, Marc, "Trade and Growth: The Case of Brazil," Department of Economics, University of California, San Diego, 2003, http://econ.ucsd.edu/seminars/muendler_brazil.pdf
- Popper, Karl, *The Open Society and Its Enemies*, Vol. 1, Princeton, Princeton University Press, 1971 [1945]
- Sachs, Jeffrey, "Shock Therapy in Poland," University of Utah, April 1994, <http://www.tannerlectures.utah.edu/lectures/sachs95.pdf>
- Shleifer, Andrei, and Treisman, Daniel, "A Normal Country," *Foreign Affairs* 83, 2004
- Wacziarg, Romain, and Wallack, Jessica Seddon, "Trade Liberalization and Intersectoral Labor Movements," *Journal of International Economics*, to appear, 2004
- Wacziarg, Romain, and Welch, Karen Horn, "Trade Liberalization and Growth," Stanford GSB, 2003, www.stanford.edu/~wacziarg/downloads/integration.pdf