Notes on Institutional Reforms

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There is a key question about institutional reform that several debates keep circling around using different vocabularies.

The Conditionalities Debate

There is the current debate about adjustment lending and the effectiveness of conditionalities in lending and aid. There seems to be some rough agreement about certain types of conditionalities where outside pressure and arm-twisting can be effective. There is equally strong agreement that in certain areas (e.g., "institutional reform") where externally imposed conditions are not effective—where reform commitment can only be "found" and "selected for" but not "bought" with aid or concessional lending. There is a large ill-defined middle ground where the "institutional optimism" of the Bank and Fund leads us to still try to use the mechanism of conditionalities although with precious little success.

Stroke-of-the-pen Conditionalities

The sorts of conditionalities that might be effective are variously called stroke-of-the-pen, pro forma, or price-based conditionalities. These names capture several ideas. Any legal act of Government or Parliament could be classified as "stroke-of-the-pen" but the problem is in the implementation or effectiveness of getting the legal action translated into changes in behavior. It is only when the legal act is effectively self-executing that we might justifiably call it a stroke-of-the-pen reform. When there is a legal requirement or tax that enterprises strongly resist and that government officials use as a basis for rent-seeking, then the well-publicized legal abolition of that requirement or tax is likely to be widely implemented.

The Bank and Fund tend confuse that sort of legal act with other types of legal acts, such as the passing of the western-professor-drafted corporate laws for Russia (see below), which require deep changes in behavior to be implemented.

Price-based Conditionalities

Another way to try to delineate conditionalities that have some hope of working is to consider ones that change some officially-established prices or exchange rates.

> "The more workable and more popular commitments are precisely those that are highly visible, verifiable, measurable and, at their best, irreversible. One thinks of a revision of the customs tariff, of the imposition of credit restrictions in order to curb inflation, or, most typically perhaps, of a devaluation." [Hirschman 1971, 206]

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Institutional Reform Conditionalities

At the other end of the "spectrum" are the conditionalities geared to institutional reform.

> Institutional reforms lie at the opposite end of the simplicity-complexity spectrum by comparison with currency devaluations: they are not for the most part amenable to treatment as preconditions; donor agencies are liable to have difficulties in keeping track of the extent of compliance; and such reforms are often imperfectly under the control of the central authorities, take time, typically involve a number of agencies and are liable to encounter opposition from well-entrenched beneficiaries of the *status quo*. [Killick et al. 1998, 40]

Even the way to characterize the "spectrum" is not a given. Killick refers to it as a "simplicity-complexity spectrum." Hirschman characterizes the "doable" end of the spectrum as "highly visible, verifiable, measurable and, at their best, irreversible" changes, so the other end of the spectrum would be conditions about changes that lack some or all of these attributes. As we will see later, Israel [1987] takes the spectrum as the continuum of "specificity." The important point is not to find some definitive characterization of the spectrum but to be clear that the ill-defined and messy spectrum is there, and that institutional optimism or the pressure to move money should not lead one to misconstrue a conditionality actually near one end as if it were near the other end.

The thinking going on in the Bank now about moving more towards "programmatic lending with fewer and simpler conditions" should be viewed as attempts to move conditionalities into the doable end of the spectrum. However, if the "fewer and simpler conditions" are on the order of "Improve the rule of law" then we still have a long ways to go.

The Shock Therapy Debate

Voucher Mass Privatization as the Shock Therapy Version of Privatization

Another recent debate where roughly these same considerations came into play using a different vocabulary was the debate between shock therapy versus incrementalism (the latter being often mischaracterized as "gradualism") in the transitional economies. The initial successes in using shock therapy approaches in stopping hyper-inflation (macro-stabilization) or in price liberalization lead various academic professors turned globe-trotting consultants into thinking that "shock therapy" would also work as a means of institutional change (e.g., the third part in the SLP trilogy of stabilization, liberalization, and privatization).

History has not been kind to those who advocated shock-therapy methods of institutional change from the Jacobins and Bolsheviks to their modern followers. Countries with enough civil society to resist institutional shock therapy (e.g., Poland with the Church and Solidarity) have done well and countries whose governments succumbed to a "market-Bolshevik" fever without sufficient countervailing civil society such as Russia[1] have suffered a devastation unprecedented in peacetime.

Corporate Law Reforms

The corporate law reforms in Russia might be a better case since the principals involved were outside the Bank and thus were capable of eventually recognizing their mistakes without discrediting their employer (and thus setting into motion all the forces to sustain errors). Bernard Black (then of Columbia Law School), Reinier Kraakman (Harvard Law School), and Jonathan Hay (HIID consultant in Moscow somewhat associated with Harvard Law School) drafted a new, modern, and academically sophisticated "self-enforcing" corporate law code for Russia. It was highly touted by western reformers and, with the help of Russian lawyers such as Anna Tarassova, adapted enough to the Russian case so that the Kremlin could ram it through the Duma into "Law." The non-incremental *tabula rasa* nature of the code was indicated by title "Corporate Law from Scratch" of the article describing the reforms in a volume of papers originally presented at a Bank conference [Black et al. 1996].

Putting a new corporate code into law [the formal *de jure* institution] and getting widespread compliance [the *de facto* institution] were two entirely different things then and now in Russia. Investors who did not follow the advice of the London Tube conductor to "Mind the gap" (in this case, the gap between *de jure* and *de facto* institutions) learned a hard lesson. One might imagine a rubber band connecting the law and the "habits of the people." When the law changes incrementally, then the rubber band exerts pressure on the habits of the people and the habits may be slowly pulled along more or less into compliance. But when the law is suddenly and drastically changed ["Corporate Law from Scratch"] then the gap becomes so large that the "rubber band" breaks and the "habits of the people" evolve into a shadow economy with its own informal rules and norms.[2]

When Black and Kraakman became legal advisors for some of the western companies investing in Russia, they also learned the hard way to "Mind the gap." Since universities are wise enough not to enshrine the views of their professors as "The Harvard Line" or "The Columbia View", Black and Kraakman were able to learn and to publicly acknowledge the mistakes without discrediting their employers [and Black has since moved to Stanford Law School]. While Hay seems to have gone the way of Conrad's "Mr. Kurtz", Black, Kraakman, and Tarassova have written a remarkable *ex-post* analysis of the Russian privatization and legal reforms that is most illuminating about institutional reforms [Black et al. 2000]. They now support "staged privatization" (i.e., an incremental strategy) as opposed to the shock therapy privatization of the voucher schemes.

Since both the Black et al. papers are available, they would be a wonderful basis for presenting some before-and-after "learnings" about institutional change.

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[1] For instance in Russia, the Church and trade unions were discredited by cooperation with the previous regime and, in stark contrast to Poland, played little if any significant role in the transition from communism to the current system.

[2] De Soto's new book [2000] is quite good on recognizing the subtle interplay between the formal law and the "habits of the people."

The Albanian Case

Another less well-known case is the Albanian corporate law. The government officials wanted to jump to modern corporations "like in Europe." They located a German foundation that was willing to fund an "adaptation" of the corporate laws of another European country, France. The new draft laws were quickly passed by the Parliament so that the Albanian government officials and legislators could brag that they now had "European corporate statutes." All they needed now was a few lawyers, a few judges, a few accountants, a few regulators, a few business people, and a few decades of institution-building experience so that the new statutes could actually be used. Any attempt to get the country to adopt laws similar to those in neighboring countries [e.g., the former Yugoslav republics of Slovenia or even Kosovo] that had evolved towards a market economy for several decades was angrily rejected. "Why do you try to get us to use these second-best or third-best laws when we can adopt the best European statutes?"

When western law professors or eastern government officials think of "corporate law reforms" as getting a corporate code passed by the legislature, then they are using the mental model of a stroke-of-the-pen reform. But when they *ex ante* or *ex post* realize that "corporate law reforms" also need to be implemented and complied with by a diverse group of organizational and individual parties all of which have their own interests, predilections, and powers, then the reformers see it as an "institutional reform" towards the other end of the aforementioned spectrum where incremental or staged strategies are more appropriate (but will meet all the usual "Why not the first-best, right now?" counter-arguments).

The Arthuro Israel Book "Institutional Development"

These considerations from the conditionality and shock therapy debates segue into the main themes of the Israel book [1987]. This book seems to be the distillation of the Bank's (including the 1983 WDR on *Management in Development*) and other development thinkers' [principally Hirschman] learnings about institutional development. The two basic concepts are specificity and competition surrogates.

Specificity

Israel takes the aforementioned spectrum as being one of specificity. The doable end of the spectrum, where conditionalities and shock therapy might have more applicability, is the end of high specificity. The classic Hirschmanian example is aircraft maintenance as opposed to dirt road or railway maintenance. The procedures are highly specific and the consequences of failure are quite definite. Either the company learns quickly to do it well or does not attempt it at all.

He gives three examples along the spectrum starting with jet engine maintenance at one end, tractor operation and repair in the mid-range, and educational counseling at the low end. The high end activities tend to be in "high technology, finance, and industry" while "those concentrated in low technology and related primarily to human behavior (social or 'people-oriented' activities) have low specificity." [1987, 49] Even within each area one could find a spectrum. In finance, setting up a stock market (even as a symbolic "cargo cult" activity) is highly specific and AID-funded technicians can be brought in for the training and initial setup. However effectively regulating the stock market is quite another matter that involves not just looking-good-on-paper regulations, but regulatory officials who will learn about and enforce compliance backed up by a judicial system that will understand and enforce the cases brought before it. Another finance example is getting the banks to build loan departments for small businesses which is quite human-relations and judgment intensive and is thus less susceptible to straight off-the-shelf 'technology transfer.' In industry, tightly linked continuous processes are more analogous to jet engine maintenance while the restructuring of failing industries is more people-oriented and judgment intensive.

Israel's discussion is very rich and full of insights about where the Bank's work can be effective in contrast to where the "standard methods" are likely to fail.

Competition Surrogates

The next step in the argument is to look at what can be done where the institutional development concerns the less specific activities. What are the sorts of pressure that will improve performance in activities of low specificity? In the marketplace, competition is the main source of pressure so 'competition surrogates' is a broader category of pressure mechanisms that will help induce change.

Israel's notion of competition surrogates is closely related to Hirschman's notion of inducement mechanisms that operate through forward and backward linkages to induce change. One thing leads to, induces, elicits, or entrains another thing through chains of "tensions, disproportions, and disequilibria." Hirschman at one point refers to the principle of unbalanced growth as "the idea of maximizing induced decisionmaking" [1994, 278]. The problem-solving pressures induced by unbalanced growth will call forth otherwise unused resources and enlist otherwise untapped energies. As a project moves from one bottleneck and crisis to another (in comparison with the smooth planned allocation of resources in a project), then "resources and abilities that are hidden, scattered, or badly utilized" [1961, 5] will be mobilized.[3] Hirschman [1984, 95] notes the connections with Cyert and March's notion of "organizational slack" [1963] based on Herbert Simon's theory of "satisficing" [1955], with Nathan Rosenberg's theory [1969] that technological innovation is strongly influenced by "inducing" or "focusing" events such as strikes and wars, and, above all, with Harvey Leibenstein's theory of X-inefficiency [1966, 1976].

WDR 1983: Management in Development

The 1983 WDR written under the general direction of Anne Krueger could be seen as a WDR-style prelude to Israel's 1987 book. There should be reliance on "markets to do what experience has shown that markets generally do best." [126] But that leaves the whole area of "government responsible for macroeconomic policy, for managing public revenues and expenditures, and for running public enterprises and public services." These are areas of low specificity sheltered from the winds of competition and vulnerable to the temptations of rent-seeking and organizational slack.

The WDR ends with four broad conclusions:

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[3] Indeed Israel takes the full quotation as the epigraph of his book; "Development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered or badly utilized." [1961, 5]

1. Good policies are relevant only if there is the institutional capacity to carry them out [i.e., specifying good policies is on the easy doable end of the spectrum while building the institutional capacity to carry them out is towards the other end of the spectrum];
2. A blueprint approach to the complexities of development should be rejected in favor of a learning approach in adjustment programs, administrative reforms, and rural development projects [i.e., apply a learning approach to the tough end of the spectrum];
3. Public bureaucracies should pay less attention to form (the easy specific part of the spectrum) and more to the substance of accountability, cost-effectiveness, and incentives; and
4. "On administrative reform, governments can achieve more through persistent but selective efforts at change, step by step, rather than through major reforms that threaten many entrenched interests simultaneously and are therefore often neutralized by them. The correct time horizon for institutional development is decades rather than years." [126-7] [i.e., "institutional development" = hard end of spectrum where shock therapy does not work]

The last contra-shock-therapy theme rings even more true after the experiences of the last decade in the transitional countries. It would be good if the earlier Bank learnings on institutional development could be picked up and enriched by painful recent experience in this WDR.

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