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The need for a new theory of economic reform

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Abstract

Debate regarding key factors determining the success or failure of policies of liberalization and privatization, illustrates the need for a concise theoretical foundation to guide decision makers as to how, when, and where to apply policies that change underlying economic structures. This paper outlines such a framework, which is based on the perception of gradations in the process of development. It also argues that the introduction of new ownership structures, market mechanisms, and financing techniques are not necessarily solutions without providing for changes in economic, societal, and legal infrastructures.

JEL classification: L33; O11; O38; O47; P11; P52

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1. Background to the debate

Since the fall of the Berlin Wall and the opening up of Communist nations, economists have promoted new ownership structures as a solution to the maximization of welfare and a way of introducing market forces into command economies. They have advocated privatization in particular as the optimal means of achieving an increase in economic growth and lifting per capital income. Such advocates claim the reduction of state ownership and control of the means of production and allocation of resources is a necessary condition for a transition to a market economy, espousing capitalistic principles tempered by mechanisms

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to ensure accountability. Those challenging such viewpoints claim arguments are propelled more by ideology than by facts, despite studies by the World Bank (1995)[1] and the OECD (1992, 2000) providing evidence linking state ownership to budget deficits and inefficiency.

Arguments for privatization consist of four themes:

- private ownership is linked to greater efficiency as agency costs provide managers with adequate incentives to achieve production efficiency;
- privatization can produce gains due to a shift from monopoly to competitive markets;
- privatization is considered more efficient by subjecting the firm to the scrutiny of capital markets;
- privatization leads to the removal of public sector constraints on efficient behaviour (Helik, 1997, pp. 27–28).

Apart from these reasons, there are other grounds for advocating mechanisms to reduce the reliance on government, such as achieving a stated political mission, for instance, helping finance certain sectors of the economy. Another rationale may be to reduce political intervention in state owned or controlled business ventures, which prevents the true commercial operations of those entities (Culpin, 1999, p. 5). This has been particularly obvious in State Owned Banks (Currie, 2000, 2001a). Such political interference can extend to the appointment of top managers, financing of government activities, offering higher than market interest rates for deposits in order to engender popularity for the government, over staffing and the extension of loans to those individuals and companies who have close associations with the government in power. This can result often in non payment of those loans and hence diminishing capital.

Privatization is not the only means of reducing state ownership and control of enterprises. Economists have also touted public private partnerships and private finance initiatives as means of promoting economic and social development. However, regulators are still intensely debating whether privatization and other ownership structures, which are not totally dependent on state ownership and control, achieve such goals or in fact cause a deterioration in welfare levels from those existing under a command economy. An example of such a debate is that between the former Chief Economist of the World Bank, Nobel Laureate Joe Stiglitz, and the Managing Director of the IMF. This occurred after Stiglitz published a book targeting the use of such policies by the IMF.

Stiglitz claimed that the IMF advocated such policies without considering factors vital to the suitability of such reform programs to a particular economy and society (Stiglitz, 2002, 1998a,b). Reformists did not understand the particular history, the social capital, the political institutions, and how political forces affected political processes (Stiglitz, 1999, p. 4). Stiglitz described the IMF as an institution mistaking means for ends. The IMF and other economists saw privatization as a success if it opened capital accounts and created a market economy. To Stiglitz the measure of success was whether such policies improved living standards and established foundations for “sustainable, equitable, and democratic development” (Stiglitz, 1999, p. 3). He also claimed economists ignored the need for continuous ongoing change, adaptation, and feedback.

[1] World Bank, “Bureaucrats in Business: The Economics and Politics of Government Ownership” (Policy Research Report Series/University Press Book, January 1995).