The post-Washington Consensus, the role of the state and institutional reforms

Alberto Paloni
Summary

- The disappointing results of Structural Adjustment have not caused a re-evaluation of structural adjustment policies but have led to the broadening of the development agenda and an extension of conditionality to areas of a more political nature (esp governance).

- The post-Washington Consensus is critical of the Washington Consensus and is much more explicit on poverty and distribution concerns, the importance of the quality of institutions and governance, the role of the state.

- However, the theory of good institutions and good governance and the view about the role of the state are based on the neo-classical constructs of New Institutional Economics which, moreover, have been used selectively by the World Bank in order to justify its agenda.

- Thus, it is argued that the post-Washington Consensus represents a hegemonic attempt without essentially altering a fundamentally neo-liberal policy stance.
### List of abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDI</td>
<td>Foreign direct investment</td>
</tr>
<tr>
<td>GSI</td>
<td>Global Standard Institutions</td>
</tr>
<tr>
<td>iff</td>
<td>If and only if</td>
</tr>
<tr>
<td>NIE</td>
<td>New Institutional Economics</td>
</tr>
<tr>
<td>NGOs</td>
<td>Non-Governmental Organisations</td>
</tr>
<tr>
<td>PWC</td>
<td>Post-Washington consensus</td>
</tr>
<tr>
<td>SA</td>
<td>Structural adjustment</td>
</tr>
<tr>
<td>SOE</td>
<td>State-owned enterprises</td>
</tr>
<tr>
<td>WB</td>
<td>World Bank</td>
</tr>
<tr>
<td>WC</td>
<td>Washington consensus</td>
</tr>
<tr>
<td>WDR</td>
<td>World Development Report</td>
</tr>
</tbody>
</table>
Summary of the Bank’s response to the results of Structural Adjustment (SA)

- Not a re-evaluation of SA
- but extension of conditionality to areas of a more political nature, esp. those seen as responsible for the adoption of good policies

  Shortcomings of SA due to lack of local capacity (both private and public) in the design and execution of the programmes
  → attention is shifted onto the mechanisms of implementation (emerging literature on the political economy of reforms)

  ○ Conditionality for ‘governance’ reforms

    Public sector management, accountability and transparency of the public sector, legal framework, corruption, military expenditure
More attention to ‘ownership’ of reforms. No imposition
Participatory approach in the setting and implementation of development policies/priorities by recipient governments

Aid programmes require ‘partnerships’ among stakeholders (recipient governments, NGOs, civil society, donors)

“Getting the institutions right” is at least as important as “getting prices right” for the success of reforms
Institutions and policy implementation

• The World Bank started to broaden its agenda in the 1990s to include attention to governance and institutions
  o *From crisis to sustainable growth* (1989)
    At the root of Africa’s development problems is a crisis of governance
  o The *Articles of Agreement* prohibited World Bank’s interference with countries’ politics
    □ The Bank and its officers “shall not interfere with the political affairs of any members, nor shall they be influenced in their decisions by the political character of the member or members concerned.”
    □ Hence, there was discussion on which aspects of governance were acceptable
    □ The details have changed over time but essentially ‘governance’ refers to ‘processes and procedures of governing’
      e.g., participation, accountability, transparency, predictability of rules & policies
Implementation problems due to insufficient attention to political and institutional factors

- Idea that standard policy reforms do not work if institutional conditions are poor
  
  e.g., trade liberalisation requires sound (i) fiscal institutions (to make up for lost revenue), (ii) capital markets (to allocate finance to expanding sectors), (iii) labour market institutions (to reduce transitional unemployment)

- New Institutional Economics is used to address the criticism that the World Bank has ignored institutions
The theory of good institutions and good governance

• Based on New Institutional Economics
  - Ronald Coase, Oliver Williamson, Douglass North
  Microfoundations and methodology of neo-classical economics

• Markets as neoclassical exchanges
  - Market transactions require a means of payment (money)
  - Markets involve the exchange of property rights

▼ Institutions are required to support the proper operation of markets. In particular:
  - An independent central bank targeting inflation
  - An effective legal structure
Institutions and economic performance

- High transaction costs → stagnation
  - Stagnation is due to inefficient markets (high transaction costs are the cause of market failures)

- Weak property rights and state intervention → transaction costs
  - Weak and contested property rights and unnecessary state interventions raise transaction costs (also through creating uncertainty)
Rent-seeking and corruption ↔ contested/weak property rights and welfare-reducing interventions

- Attempting to enforce property rights or remove unnecessary government interventions is made difficult by rent-seeking and corruption (interest groups try to influence the state to distort property rights and intervene in their favour)
- Weak property rights and welfare-reducing interventions create incentives for rent-seeking and corruption

Rent-seeking and corruption ↔ unaccountable government

- Rent-seeking and corruption benefit small groups of people but they are sustained because of unaccountable governments. Thus the fight against corruption and rent-seeking requires reforms to improve democratic accountability.
- Rent-seeking and corruption can be used to overturn democratic governments
In the early 1980s (SA/WC): removal of state interventions → (1) market efficiency (2) reduce rent-seeking and corruption

New governance agenda (PWC): (1) directly fight rent-seeking and corruption (2) accountability reforms

All of the key links should be attacked simultaneously or market efficiency would not improve (see the next slide)

‘Market-enhancing’ governance

It attempts to make markets more efficient (by focusing on rule-of-law reforms, anti-corruption strategies, and competition policies)
Property rights instability and welfare-reducing interventions ↓ *iff* rent-seeking and corruption are directly addressed

↓ *iff* accountability and democratisation are promoted

↑ *through* pro-poor service delivery (empowering and raising the expectations of the majority)
• The World Bank has used NIE selectively, in order to provide a theoretical foundation for its policy priorities and justify its expanding agenda
  o Not a rethinking but a renewal of its commitment to its neo-liberal policy agenda
  o Governance capabilities in advanced capitalist countries as a model for developing countries
Bureaucrats in business (1995)

- Superiority of private over state enterprises
- NIE is used to justify this conclusion once the empirical analysis has ‘proved’ this result
- Williamson: imperfect information \( \rightarrow \) opportunism \( \leftarrow \) rewards and penalties

Managers in SOEs act opportunistically: they negotiate easily achievable targets because, as political appointees, they are not influenced by rewards and penalties

- But crucial insights are disregarded:
  - Williamson’s concept of ‘credible commitments’
    - While the importance of credible commitments is reflected in the view that managers in SOEs have little incentive to fulfil contractual obligations, an explanation based on how private/public sector contracts deal with opportunism does not explain why SOEs may work well (e.g., Singapore)
    - Williamson criticised the *East Asian Miracle* for overlooking how the state made credible commitments which induced investment
Williamson’s concept of ‘remediableness’: institutions can be improved through incremental changes

- There is no ideal institutions. All institutions are flawed
- Improving existing institutions > introducing new ones (because of history, political difficulties, etc)
- Instead, the WB has an institutional ideal
  
  Every country should adopt a set of ‘good institutions’, seen as necessary

The selective use of NIE has allowed the WB to rationalise its privatisation agenda

- Most important impact: justification for the discussion by the WB of politics and corruption with recipient governments and the wider use of governance-related conditionality
**WDR (1997), *The state in a changing world***

- Most significant use of NIE is in defence of WB policy on liberalisation, regulation, and industrial policy
- Williamson: opportunism with imperfect information
  
  This could suggest a need for information and coordination (i.e., an industrial policy along the lines of East Asia) but....

- North: distinction between formal and informal institutions
  
  - Institutions are “humanly devised constraints that shape human interactions”
  - They are *informal* (taboos, customs, traditions, which originate from culture and history) or
  - *formal* (contracts, laws, property rights, which originate from the legislative, executive and judicial branches of the state)
  - Informal institutions are especially important in developing countries

→ Since the institutional framework and administrative capabilities are weak in developing countries, regulatory rules should be simple and market-like

  - This would ensure that the government’s commitment to refrain from arbitrary intervention can be credible
Industrial policy is inappropriate because such investment coordination requires levels of public and private institutional capabilities which are not available in most developing countries.

- This WDR uses NIE both to explain why industrial policy may be required and to reject such arguments!

- The argument that the extent and nature of regulations should conform to capacity (rather than need) provides justification for the WB’s emphasis on deregulation.

  - Over-regulation is defined in relation to state capacity:
    - Thus, limited capacity to implement regulations means that many activities are over-regulated.
  - It also suggests that the role of the state could differ significantly across countries against ‘one size fits all’
BUT paradoxical:
- Developing countries with poorly developed markets $\rightarrow$ more market-like mechanisms
- Richer countries with better formed markets $\rightarrow$ more regulation, more heavy-handed state intervention

Without underlying capabilities, developing countries should pursue neo-liberal policies as usual
• The IMF joined in the new agenda
  o Guidelines on the role of the IMF in governance issues (1997): economic side of governance (including transparency of government accounts, effective public resource management, regulatory stability of the private sector)

• Stiglitz and the post-Washington Consensus
  o Appointed as World Bank’s chief economist in 1997
  o One of the main proponents of New Institutional Economics
  o The PWC emphasises the importance of ‘good’ institutions for growth → a new mantra: ‘getting the institutions right’.
WDR (2002), *Building institutions for markets*

- Necessity to expand the agenda for institution-building in support of markets
- The state is essential for putting in place the appropriate institutional foundations for markets
  - Special role as a provider of public goods, e.g., laws that define property rights and judicial institutions that enforce these rights and establish the rule of law
- State intervention should be confined to building institutions in support of markets
  - The state can impede the development of markets through arbitrary exercise of state power, over-taxation, corruption, short-time horizons, cronyism, and the inability to uphold public order
- Underdeveloped developing countries’ markets do not require greater regulation and state support but deregulation and simpler, market-like rules
Broadening the development agenda

• The new agenda has consisted in the augmentation of the WC reforms with a list of ‘second generation’ reforms (meant to create the PWC)
  o Measures to reduce corruption, increase transparency in public administration and in the formulation of public expenditure, to improve corporate governance, participation in WTO, introduction of financial codes and standards
  o Significant increase in governance-related conditions, especially since the Heavily Indebted Poor Countries (HIPC) initiative, 1996
  o Governance does not displace any of the standard conditions but adds new ones
• Characteristics of the broader development agenda:
  o Commitment to adjustment policies
  o Each new policy as a complement to adjustment
  o Theoretical core for each new element of the agenda based on neo-classical economic theory

• These enhanced conditionalities were welcomed by the IMF
The emergence of the post-Washington Consensus: key factors

- Countries’ experiences pointing to limitations of WC:
  - Lack of success of reforming countries
  - Success of those diverging from WC policies

- Governance concerns
  - Privatization, liberalisation, decentralisation have undermined the effectiveness and legitimacy of state institutions → state collapse/failure
Paradoxical, since the reforms were intended to eradicate rent-seeking and corruption (which were brought about by excessive state intervention)

- In practice, privatisation has been hurried through without an appropriate framework for regulation → absence of a transparent and open bidding process
- Liberalisation → facing the insecurity of global competition, industrialists have tried to buy political favours
- Decentralisation without (i) adequate preparation of local bureaucracies and (ii) transfer of financial resources → increase in corruption
Increasing significance of Japan (second most important shareholder) as a major donor

- Overseas Economic Cooperation Fund’s criticism to SA:
  - unsustainability of growth → need for investment promotion
  - need for protection to develop viable export industries
  - market mechanism would not mobilise development finance → subsidised lending
  - modality of privatisation

- The *East Asian Miracle* Report:
  - admitted that industrial policy had been successful
  - the real reason for success was ‘getting the basics right’
  - state intervention should not be repeated elsewhere
    - State capability (high quality bureaucracy) was unavailable
    → but it broke the state vs market dichotomy
The criticism to the Washington Consensus by Stiglitz

- Failure in understanding economic structures in LDCs which may require state intervention
- Focusing on too narrow a set of objectives
  - too much emphasis on price stability
  - budget deficit is a problem depending on the circumstances (e.g. economic situation, the cost of financing)
  - current account deficit is a problem depending on the circumstances (whether it is for consumption or investment, if it is financed by FDI or debt)
  - overlooking the importance of output stabilisation (to avoid unemployment)
  - the importance of financial development for macroeconomic stability
• Focusing on too limited a set of instruments
  — agricultural prices liberalisation
    but no attention to the existence of functioning markets for inputs or to credit availability and infrastructure (esp. roads)
  — interest rate liberalisation
    with thin and underdeveloped markets → high interest rates, without improving credit availability

• Confusing means and ends
  Privatisation and liberalisation as ends, although they lead to inequality and instability
New features of the Post-Washington Consensus

- The role of the state

“The policies advanced by the Washington Consensus are incomplete and misguided (…) 

Making markets work requires also financial regulation, competition policy, policies to facilitate the transfer of technology (…) The state has an important role to play in appropriate regulation, industrial policy, social protection and welfare (…) 

We should not see the state and markets as substitutes [but as complements, whereby, by undertaking those actions, the government makes] markets fulfil their functions better”

(Stiglitz, 1998, *More instruments and broader goals*)
• Complementarity between market and state
  o To create a favourable environment for private investment
    Establishing and defending property rights, contract enforcement, political and macro stability, providing public goods, infrastructure and regulation (esp. of the financial sector)
• Partnership between state and the private sector (inc. both private profit and non-profit sectors)
  o Provision of social services by private contractors, NGOs and community groups, with the state playing a role as regulator, purchaser, and residual provider
  o Introduction of quasi-market mechanisms to improve the efficiency of the state
    □ e.g., through the introduction of competitiveness and incentives to improve the quality of bureaucracy
• There is suspicion of the state
  o Intervention must be limited, as the state can be captured by interest groups → market failure should not be replaced by non-market failure
Good governance

- Defined as processes and procedures of governing
e.g.: participation, accountability, transparency, predictability of rules & policies
→ BUT ‘goodness’ is evaluated without reference to outcomes
  (good governance processes but failure to promote development!)

- Good governance becomes an end in itself rather than a means for achieving economic development

- “Good governance” reforms: introducing particular types of formal institutions (typical of advanced countries) into LDCs:
  - ‘Global standard institutions’
    Particular (mostly Anglo-American) forms of institutions that all countries should adopt:
- political democracy; independent judiciary; professional bureaucracy (ideally with open and flexible recruitment); small public enterprise sector (supervised by a politically independent regulator); developed stock market (with rules that facilitate hostile M&A); financial regulation to promote prudence and stability (though a politically independent central bank and the BIS capital adequacy ratio); shareholder-oriented corporate governance system; labour market institutions (to guarantee flexibility)
  
  - Note that GSIs are increasingly imposed through governance related conditionalities

- A style of public administration and management (“New Public Management”)

  Government run according to private sector styles, using market mechanisms, client orientation, and performance management to increase productivity
This type of “good governance” reforms...

• ...are related to a particular view of the role of the state
  o Market enhancing
    (defending property rights, maintaining good rule of law and contract enforcement, minimising rent seeking and corruption, achieving transparent and accountable provision of public goods)

• ...demand a complex set of reforms across many institutions
  o Constraint: financial resource base of LDCs is very weak
    → eradication of corruption may be the outcome of development rather than a precondition
    → Starting growth may not require extensive institutional reforms
  o The view of good institutions as preconditions → unfalsifiable policy prescriptions
    □ There is always some other institution that should have been reformed
The evidence ‘in favour’ of market-enhancing governance

- Based on cross-country regressions which find a positive relationship with economic growth.
- But there are problems:
  - Direction of causality (growth could provide the resources for the provision of market-enhancing governance)
    - Example: Rule of law
      - Plotting all data against growth rates appears to produce a positive relationship
      - Breaking down the sample into groups changes the results:
        - (i) advanced countries; (ii) diverging developing countries (growth rates lower than the median advanced-country growth rate); (iii) converging developing countries (growth rates higher than the median advanced-country growth rate)
    The two developing-country groups have the same mean and dispersion of the rule of law indicator: the rule of law cannot discriminate between high and low growth developing countries
    - The same pattern emerges with other indicators of market-enhancing governance, e.g., corruption, political accountability, etc.
    - Thus, developing countries do not in general solve market failures through good governance capabilities
Problems exist also with regressions using instrumental variables and long historical data series.

- Long-run correlation between market-enhancing institutions and income per capita
- Necessity/sufficiency at early stages of development?
  - Historically, *no advanced country achieved significant ‘good governance’ capabilities before it developed*
  - The sequence of reforms identified in the good governance strategy was never actually followed
  - Debate: good rules are not relevant without capabilities to enforce them
    - Example: property rights. In developing countries the tax base for the protection of all property rights as a public good does not exist
      → A comprehensive rule of law is desirable and should be pursued but, if it cannot be effectively enforced, it should not be a policy priority
Recommended reading


Khan, M, 2007, Governance, economic growth and development since the 1960s, DESA Working Paper No. 54 (New York: United Nations Department of Economic and Social Affairs)


