

# Redefining the Role of the State:

*What* should it do? *How* Should it Do it? And *How* should these decisions be made?

Joseph Stiglitz, Senior Vice-President and Chief Economist  
The World Bank  
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Both the past praise and the current criticism of the East Asian miracle have brought the question of the role of government to the forefront. While the economies were growing quickly, incomes were rising, literacy rates were increasing, and poverty was dwindling rapidly<sup>1</sup>, scholars were quick to note that in almost every one of East Asian cases, government played a far more active role than typically envisaged in what has come to be known as the Washington consensus<sup>2</sup>. Governments went beyond the conventional prescriptions of sound macro-economic policies, including low deficits and inflation. They put markets at the center of their development strategies, but they were not loath to intervene in markets, or, to use Robert Wade's expression, to "govern markets."<sup>3</sup> The East Asian states set out to create and regulate institutions, which promoted savings and helped allocated resources, including scarce investment. They promoted investments in infrastructure, human capital, and the advancement of technology.

The recent turmoil in East Asia has, in some circles, cast doubt on the public-private partnership that characterized the region's development strategy. The accusations of "crony capitalism," overbearing state direction of investments, and lack of transparency have, in some minds, discredited government involvement in development. I would argue that the critics have been too harsh - after all, the past achievements in accumulating

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<sup>1</sup> In Indonesia, so extensively criticized in the press recently, charges of so-called "crony capitalism" have obscured the fact that in two decades, the poverty rate has been reduced from over 60 percent to 11 percent.

<sup>2</sup> See Williamson (1990) for a list of the Washington Consensus principles. There is by now a large literature detailing the ways in which East Asia diverged from some of these policy norms, but this is not the occasion to review this literature. For some of my personal views, see Stiglitz (1996a) and (1996b). For some more comprehensive views, see World Bank (1993).

<sup>3</sup> Wade (1990).

savings, promoting investment, and developing human capital cannot simply be erased. In historical perspective, financial crises and economic downturns are not a new phenomenon in capitalist economies. Furthermore, several countries in the region, most notably China<sup>4</sup> and Taiwan (China) seem to have weathered the storm quite well. Nevertheless, the depth of the crisis in countries such as Korea, Thailand, Malaysia, and Indonesia does provoke questions.

We have much to learn from East Asia and the East Asian model, perhaps even more as we set about trying to ascertain not only the lessons of their remarkable growth, but also the lessons of their current crisis.

The discussion of the role of government is vital for improving our development strategy. There is a growing consensus that governments can play a vital role in successful development efforts, but we also recognize that the wrong kind of government intervention can be highly detrimental. We have recognized that the scope and effectiveness of government activities, rather than simply the size of the government's budget or personnel, is the key issue. Within a given size range, governments' effectiveness can vary widely with the scope of its activities: they can do too much of some things and too little of others, and redirecting the state's efforts could produce benefits on both accounts. These are all important issues.

I wish to focus this paper, however, on the more fundamental question, which underlies this discussion: "How are decisions about the role of the state made?" The processes of government itself affect the answers to questions about the size and scope of the state. Improving these processes, an effort in which I have been involved over the past

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<sup>4</sup> China, in particular, departed from standard doctrines in its transition from socialism to "market socialism with a Chinese character." As Russia and other transition economies retracted the state and focused on privatization as a first step to competition, for example, China put off restructuring of the state-owned enterprises and focused instead on encouraging the growth of *new* private businesses to compete with the public enterprises, eventually forcing a restructuring on their part. Nevertheless, (or perhaps consequently), its development performance has been impressive. China, alone, accounted for nearly two-thirds of the increase in incomes of low-income countries during the previous two decades, though it accounted for but 40 percent of the low-income countries' population, and 25 percent of aggregate incomes at the beginning of the period. If China's 30 provinces were treated as independent data points (and most have populations of tens of millions of people), the twenty fastest growing units in the world over the last two decades would all be in China (World Bank 1997).

half decade, may provide the most enduring way of making progress in the other areas. Critics of government interventions claim that such interventions are inevitably welfare reducing, and simply attempts by one group to enhance their welfare at the expense of others, are at best unproven, at worse true. The question is, “Are there ways of designing governmental institutions which enhance the likelihood of, if not ensuring that, public interventions are welfare enhancing?”

Part I of this paper will review current thinking on the appropriate role of the state, while in Part II I put forward five new propositions for improving the processes which underlie government actions.

## **The Economic Role of the State**

An inquiry into the appropriate role of the state must begin with the question, “In what ways is the state different from other organizations in society?” The answer relates to the nature and source of its powers. The state and its representatives are the sole basis of the *legitimate* use of compulsion both to do certain things (such as being drafted into the armed forces) and not to do certain things (such as selling drugs). Membership in the “state” is a default condition, defined automatically for those meeting certain qualifications such as birth or residence. The state’s jurisdiction extends to all of those residing within its boundaries or who accept citizenship within the state.

These extensive powers are matched by certain limitations. First is the inherent inability to make credible commitments. The state’s unique powers of compulsion lead it to be the enforcer of contracts, but leave it without an entity to enforce its contracts and allow it to demonstrate its commitment to certain policies. The state can impose certain obligations on itself, including obligation to fulfill its contracts, but no government can impose obligations on its successors or even do much to stop itself from reneging on previous commitments. While Buchanan emphasized the role of Constitutions, there are wide areas where the Constitution provides insufficient commitment. Governments can commit themselves weakly by imposing rules, which affect transactions costs, but this imperfect commitment mechanism entails trade-offs in terms of future flexibility. These transactions costs may provide for stability, but can also inhibit governments’ ability to adapt quickly to changing circumstances.

Our political systems have created further restrictions to prevent potential abuse of government powers. The regulations associated with government procurement and civil service are some of the most notorious examples of this “red tape.” Both are usually designed to ensure equitable treatment of all citizens and to prevent some groups from using the powers of the state to enrich themselves at the expense of others, but both inhibit the government’s ability to function efficiently. The political process also defines the rules by which those in decision-making positions are chosen and the process by which

actions can be undertaken. The common system of passage by Parliament and approval by the Executive, for example, is, again, designed to prevent the abuse of power, but often makes decision-making slow and cumbersome.

### *The View from the Market: Three Conservative Propositions*

Many critics of the government base their beliefs on premises about the market: first, that markets, by themselves, yield efficient outcomes; and second, that efficiency is more important than, say, distribution between persons or generations.<sup>5</sup> Based on these judgments, critics of government have argued

- (i) Government is unnecessary because anything the government can do, the private sector can do better;
- (ii) Government is ineffective because anything the government does, the private sector can and will undo;
- (iii) The incentive structures inherent in public institutions imply that government actions generally decrease societal welfare, or, at the very least, inhibit productive economic activity by taking resources away from one group and giving them to another, often less deserving group.

Recent advances in welfare economics have highlighted several shortcomings in these market-focused propositions for the role of government by pointing out new conditions under which markets are not Pareto efficient. Externalities (such as associated with pollution or innovations) and public goods are not the only factors that create stumbling blocks for an otherwise market efficient economy. Imperfect information and incomplete markets - an extremely common condition - have been added to the list of

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<sup>5</sup> The absence of an emphasis on distribution may stem from a simple lack of concern about distributional issues or from the belief that the adverse effects of redistribution are so great that the costs exceed the benefits.

factors, which give rise to problems in the market economy.<sup>6</sup> It is now recognized that imperfections of information (about individuals or evaluations of public goods, for example) prevent Coasian bargaining from adequately resolving externality problems. (See Farrell (1987), Stiglitz (1994), Dixit and Olson (1997).) There never was a presumption that markets yielded an optimal societal or generational distribution of income and now there does not seem to be any basis for the presumption that markets yield efficient outcomes.

The fact that markets do not achieve efficient outcomes, of course, does not automatically mean that government intervention can improve upon matters, which is why these *conservative* propositions need to be dealt with through an assessment of *government* powers and limitations.

From the vantage point of our analysis, we can see that the first proposition is simply not true: government has powers that the private sector does not have. The second proposition is even more obviously wrong. True, there are some highly idealized models, such as those involving the neutrality of money, in which the proposition of government ineffectiveness may have some limited validity. More generally, however, whenever governments take actions or have rules that change relative prices or redistribute income, and whenever the private sector has imperfect information concerning government actions, the state's policies cannot be fully undone<sup>7</sup>.

The third proposition is the most difficult to deal with. Certainly, there is no general proposition concerning the efficiency of actions, which emerge from political processes. There are good reasons to believe that public and private interests are far from perfectly aligned. Indeed I have argued elsewhere (Stiglitz, 1994) that the principal agent problems which arise in the public sector are, in many respects, not dissimilar to those

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<sup>6</sup> More precisely, markets are not even constrained Pareto optimal where due attention is paid to the costs of information and of establishing markets. See Greenwald and Stiglitz (1986).

<sup>7</sup> Even the proposition concerning monetary neutrality is valid only under highly restrictive conditions. For instance, if the government has a rule which increases the money supply in different amounts in different states of nature (keeping the mean increase in money supply fixed), then the demand for money will be affected (so long as there is not risk neutrality), and hence the price level, and real money supply will be affected differently in different states of nature, and hence the level of capital accumulation. See Greenwald and Stiglitz (1986).

which arise in large corporations in the public.<sup>8</sup> In both cases, the rewards of managers are at best only loosely linked to performance. Managerial rent seeking within the private sector (Shleifer and Vishny, 1989, and Edlin and Stiglitz, 1995) can be every bit as problematic as rent seeking in the public. There have been important instances in which government actions have been welfare decreasing. Nevertheless, as a historical proposition, it is also the case that government has played a significant positive role in the countries with the most successful development strategies, including the United States and the countries of East Asia.

*Market failure, public failure, and new views of the role of government:*

While market failure theories dominated thinking about the role of government in the decades following the proof of the fundamental theorems of welfare economics, public failure theories began to dominate discussions in the Reagan/Thatcher era. The public failure theories can be thought of as an elaboration of the Third Conservative proposition above. It was asserted that

- (i) Special interest groups would, without constitutional bars, seek to establish market impediments that generate rents;
- (ii) The opposing public interests were too diffuse to successfully oppose the special interests. While aggregate costs might exceed aggregate benefits for society, a public goods problem arose when costs were much more diffuse than benefits.
- (iii) Competition for rent seeking tended to dissipate the rents, but the rent dissipation simply added to the waste.

While there is plenty of evidence to suggest that rent seeking was important, these

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<sup>8</sup> There is, however, one fundamental difference: increases in capital values from good managerial values are typically partially captured by managers in private corporations (since to *some* extent, managers participate in the increase in the value of the firms which they manage), while increases in the “capital value” of public enterprises are more difficult for public managers to capture. (In practice, private managers may capture a relatively small fraction of the increase in capital values. See Jensen and Murphy, 1990.)

propositions do not seem to adequately describe the process. First, there is a curious intellectual inconsistency: while many conservatives seemed to argue that Coase's theorem (or what might more appropriately be called Coase's conjecture) worked well in the private sector, it seemed to have no sway in the public. Inefficiencies within that sector did not seem to get "bargained out." Second, it was simply assumed that there was perfect competition in rent seeking. In reality, however, competition in rent seeking was every bit as imperfect as competition elsewhere in the economy. There are quite general theorems which established that if there were even epsilon sunk costs, even strong potential competition was not enough for the dissipation of imperfect competition rents. (See Stiglitz, 1987). Third, rent-seeking activities tend to be concentrated in certain sectors, e.g. trade and agriculture, although there are clearly opportunities for significant rents elsewhere. Understanding why these are not pursued, or at least successfully pursued, may provide important new insights into the rent-seeking process.

### *State and Society: An Interactive Partnership*

The first attempts to combining the previous analyses of market and government failures resulted in efforts assign separate tasks to the public and private sectors. In earlier discussions, some sectors were thought of as largely within the domain of the public sector, others as largely in the jurisdiction of the private. Today, however, the question is posed somewhat differently: "How can government and the private sector act together, as partners, or, in the more technical jargon of economics, in a complementary fashion?"

One can ask this question about the financial sector, for example. Lending activity should clearly be primarily the responsibility of the private sector. Yet there is a large public role. Government has helped create new institutions, where the private sector failed, for one reason or another, to adequately address needs. The role of government in the mortgage market in the United States, in establishing long-term credit institutions in Japan, or in establishing thick bond markets elsewhere, are just a few examples of this activity. Government is also needed to regulate financial institutions, not only to ensure

competition, but also to maintain the safety and soundness of the financial system.<sup>9</sup>

The general theory of this “partnership” has recently been set out.<sup>10</sup> The government can change the “game” that the private participants are playing in ways which are welfare enhancing. While older literature focused on dissipative rent seeking, this newer work has emphasized how governments can create rents which enhance incentives for, say, prudent behavior in the financial sector, or more generally for wealth creation. The rents associated with access to foreign exchange and credit which were distributed to those firms who were most successful in exporting provided much of the spur that led to the success of East Asia. (See World Bank, 1993). Not only can government actions thus improve the behavior of market participants, but the government actions themselves can be shown to be “incentive compatible,” that is, under plausible hypotheses concerning government objectives, such actions can be shown to be in the interests of the government itself.

### *Improving the performance of the public sector*

As understanding concerning *what* the appropriate role of government is has increased, attention has turned to a new question, *how* to improve the performance of the public sector. It is now recognized that government can avail itself of many of the same incentive mechanisms that the private sector uses. Government can use markets and market-like mechanisms.

- (i) It can use auctions both for procuring goods and services and for allocating public resources.
- (ii) It can contract out large portions of government activity.
- (iii) It can use performance contracting, even in those cases where contracting out does not seem feasible or desirable.

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<sup>9</sup> For a fuller articulation of the role of government in this sector, see Stiglitz (1992). There are further roles for government in consumer protection and in ensuring that underserved groups have access to credit.

<sup>10</sup> See Hellman, Murdock, and Stiglitz (1995), Hellmann and Murdock (1995), Aoki, Murdock, Okuno-Fujiwara (1997).

(iv) It can design arrangements to make use of market information. For instance, it can rely on market judgments of qualities for its procurement (off-the-shelf procurement policies); it can use information from interest rates paid to, say, subordinated bank debt to ascertain appropriate risk premiums for deposit insurance.

### **New Issues**

Today, I want to push the discourse on the role of the state a little bit beyond the basic what and how, by pushing the discussion one step back to ask, “What can we say about the process by which these decisions get made?” It is natural that our discussion should have evolved to this point. In the early stages of the discussion of the role of the state, we had hoped to be able to derive simple rules -- the provision of defense is the responsibility of government, the production of steel is the responsibility of the private sector. As the debate has advanced, however, the hard questions, those that the rules do not cover, have surfaced. When confronted with the question of “What to do where there is a market failure, or at least the potential of a market failure, but where it is not obvious that government interventions will improve matters?,” for example, the maxim “Undertake the public action if it improves, or is expected to improve, social welfare” is of little help. Reasonable people may disagree in their judgments, and special interests will always claim that the actions which are intended to help them are really in the general interest. This is the area where policy debates center.

Thus, the question which we need to ask is, “Are there *processes* or rules of decision-making which are more likely to result in decisions which are in the public interest, rather than in the private use of public interest?” My remarks are largely based on close observation of the political process in the United States over a long period of time, but particularly in the last five years. During this period, I had frequent occasion to observe special interest groups. The question I asked was, “How could their influence be curbed?”

Part of the answer -- reform of campaign finances -- has been noted repeatedly in

recent public discussions in the United States. Reducing the need to raise such levels of funds (e.g. by providing free air time to those who are willing to limit campaign fund raising); subjecting contributions to more sunshine; and restricting the level and sources of contributions, or of the actions which elected officials can take on donors' behalf or in the area where they have received contributions would all be helpful in reducing the influence of special interests.<sup>11</sup> Here, however, I want to focus on some strategies that have not received as extensive discussion.

Many of the issues I will be discussing in this section -- participation in decision-making, of consensus processes versus more self-interested advocacy processes -- are often approached from a broader philosophical perspective. Many of those who believed in consensus processes put greater emphasis on the notion of *community*, an emphasis which is somewhat foreign to traditional economic approaches which take a self-interested, rational, individual as the basic unit of analysis. In this case, interactions with others matter only to the extent that they satisfy the individual's *own* preferences. Many outside the very individualistic Anglo-American cultures would emphasize the importance of these communitarian values.

I want to base my discussion here not on these statements of values, but on other grounds, on *positive* economics and *instrumental* bases. I discuss five general propositions for improving governance.

*Proposition 1 for a better government: Restrict government interventions in areas in which there is evidence of a systematic and significant influence of special interests.*<sup>12</sup>

The first strategy is to reduce the allure of "rents" by limiting government action in areas where special interests have had strong sway, and where the benefits of special

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<sup>11</sup> It is ironic that ethics laws prohibit officials from owning shares of stocks in companies that might be affected by the decisions taken, but do not prohibit elected officials from receiving money from the same companies.

<sup>12</sup> Some people go further: restrict all government interventions into the market, including industrial policy. This broader set of restrictions is more problematic. I have tried to state here a set of propositions with which most economists, regardless of their ideological persuasion, would agree.

interest legislation are limited. There are several difficulties in such a strategy. First, existing interest groups are unlikely to relinquish the rents that they have gained.<sup>13</sup> Second, government's inability to commit makes such "abstinence" policies difficult to maintain and the transactions costs required for even imperfect commitment may create unforeseen problems in the future. That is why some of the most significant progress in these areas has occurred in the context of international trade negotiations.<sup>14</sup>

The important question to ask in identifying the areas which government should avoid is, "Would the adoption of rules prohibiting (or making it more difficult for government to take) action in these areas bring with it benefits that exceed the obvious costs?" I can mention several areas where "abstinence" might be beneficial. As I noted before, there are some specific areas where rent-seeking special interests tend to gain a foothold. Although I and most other economists are convinced that while there are some instances in which trade impediments might be desirable in a world of benevolent leaders, trade interventions in practice predominantly reflect special interests and are welfare decreasing. One of the reasons that trade interventions may be more frequent is that one side of the interventions - the loss of profits of the "outside" producers, is not represented in the political process, while the gain in profits of the "inside" producers is represented. By contrast, in commodities which are *purely* domestic, both losers and winners are represented and the gains from price increases to producers are just offset by the losses of users. Agriculture may represent another extreme case where the users (consumers) are highly diffuse (virtually everyone in society is a consumer) while the producers are highly

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<sup>13</sup> Replacing the current below-market prices for grazing permits with auctions, for example, would have been good for the budget, good for economic efficiency, and good for the environment. Not surprisingly, however, it was strongly resisted by ranchers. Interest groups fearing a reduction in rents are also likely to resist seemingly Pareto-improving changes which make these rents more visible and hence more vulnerable to attack. Farmers did not oppose the conversion of the United States' milk cartel and other distortionary agricultural programs into welfare equivalent lump sum payments because they would be worse off in the short run, but because the increased transparency made the abolition of the implicit and explicit subsidies more likely. See Stiglitz, 1998.

<sup>14</sup> The international trade mechanisms seem to have served as a more effective commitment mechanism than domestically-imposed transactions costs. Those resisting opening up trade or abandoning farm support programs outside of international trade negotiations sometimes liken it to unilateral disarmament. But this is wrong: one of the most widely accepted propositions in economics is that in competitive markets, a country which lowers its trade barriers benefits itself.

concentrated.

Many of the interventions in both agriculture and trade take the form of restrictions to competition rather than explicit subsidies. These interventions help enforce cartel and cartel-like arrangements which enhance the industries' profits at the expense of consumers. Special interest groups have become adroit both in cloaking their pleas under the mantle of general interest and in developing euphemisms which hide the restrictive nature of the desired interventions. The milk industry in the United States, for example, refers to its request for a cartel arrangement as "self-help."

*Proposition 2 for a better government: There should be a strong presumption against government actions restricting competition; and there should be a strong presumption in favor of government actions which promote competition.*

Policy-makers should concentrate on enhancing competition. Government restrictions on competition, almost always associated with a decrease in welfare, are one of the most common symptoms of undue influence by special interests. Although most would agree that promoting competition and acting as a "referee" in the market economy are key government roles, the state often succumbs to pressure to reduce competition. In some cases, the most vocal special interest groups are not firms, but workers. Thus, in the United States, while there is vibrant competition between public and private institutions in the provision of higher education, such competition is severely restricted at the elementary and secondary level. This class of interventions marks the subversion of the general good to the particular good as the government succumbs to pressure to protect certain groups from competition.<sup>15</sup>

Just as few are explicit in their search for special interests benefits, few are explicit

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<sup>15</sup> This example also illustrates the difficulty of separating private from public interests. The advocates of public schools point out their role, for instance, in social integration. What disrupts that perspective, however, is the fact that the public monopoly has given rise to social segregation based on residence; suburban schools are often, or perhaps typically, far less integrated than urban private schools, especially urban parochial schools. The concern about the separation of church and state can, and has been handled, in other ways, e.g. by restricting teaching of religious subjects to certain periods.

in their attempts to reduce competition. Subsidies to ethanol, for example, continue under the guise of promoting the “general interest” by reducing environmental damage and dependency on foreign oil. In fact, the fuel is economically inefficient and bad for the environment.<sup>16</sup> Similarly, many groups claim to seek protection from “unfair” or “disruptive” competition. This is particularly important in the so-called unfair trade laws - such as the anti-dumping laws. The presumption underlying these laws seems to be that any firm that undercuts domestic producers must only succeed in doing so by engaging in some unfair trade practice. The standards for unfair international trade laws are completely different than those associated with antitrust laws, the domestic equivalent. Domestic firms have increasingly used the dual standard as protection from foreign competition.<sup>17</sup> The correlation between government actions and the electoral cycles is also perhaps noteworthy. Impending elections appeared to influence the U.S. decision to restrict Mexico’s “unfair” undercutting of America’s tomatoes in 1996. Mexico had simply succeeded in importing improved technology for growing tomatoes, especially tomatoes that were robust enough to survive shipping.

*Proposition 3 for a better government: There should be a strong presumption in favor of openness in government and against secrecy.*

Secrecy, or restricted information, is often used by government officials to restrict outside participation in decision-making. The resulting exclusivity of the decision-making process increases both the influence and the rents to be had for government officials. Limitations on information, in effect, restrict competition in the decision-making process.

Increasing openness can be a powerful tool in reducing the influence of special interests and improving government performance. First, sunshine is a strong antiseptic

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<sup>16</sup> Ethanol’s viability in the U.S. requires huge subsidies - in some cases close to a dollar’s worth of subsidy for a dollar’s worth of ethanol. Worse still, producing ethanol requires a large amount of energy so that the net reduction of oil imports as a result of ethanol production is far less than the ethanol usage itself. Ethanol derivative additives also increase the volatility of gasoline and thus add to air pollution and reduce fuel efficiency.

<sup>17</sup> Thurow (1985) has noted that, “if the [anti-dumping law] applied to domestic firms, the top twenty firms in

that often discourages, or at least increases the cost of the more outrageous forms of special interest. Second, secrecy makes it more difficult to correct errors and to evaluate officials. Indeed, concern about exposure of mistakes may be even a greater motive for secrecy than concern about hiding the influence of special interest groups. Third, secrecy creates rents for those who have information, giving them something to exchange. While the exchanges between government officials and the press seldom are monetary, the exchanges which occur are no less iniquitous. It is not only the occasional puff piece extolling the virtues of the provider of the information, but, more importantly, the distortions in information which are harmful. Finally, secrecy means that information is often revealed in a less continuous process. Just as large adjustments associated with fixed exchange rates lead to more economic instability, so too do large, sudden, blasts of information.

Government officials have always sought to find rationale for the secrecy which creates information rents to be exchanged with the press and those willing to make campaign contributions (their clientele) and protects them from criticism for mistakes. How often have we heard the tantalizing “If you only knew what I knew, but regrettably, I can’t tell you.”? Secrecy creates the aura of authority that is essential for the effective exercise of power. The emperor may have no clothes, or far fewer clothes than is generally recognized, and part of the objective is to keep *that* secret.

In economic matters, however, governments have recently come up with a new and powerful rationale for secrecy: discussions (of anything) may disturb markets. It is ironic that many of those who most ardently put forward this argument are those who *believe* in the importance, and presumably, rationality of markets. Their support of secrecy seems at odds with this belief, for rational markets should be related to the basic fundamentals which are seldom altered in important ways by the pronouncements of the beliefs of one government official or another. In fact, the fundamentals *do* seem to be what ultimately matters. In the United States, Alan Greenspan’s attempt to let a little air out of what he worried was the stock market’s bubble by referring in December 1996 to the market’s irrational exuberance demonstrated that even statements (other than actions, or

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the Fortune 500 would have been found guilty of dumping in 1982.” Discussed in Stiglitz (1997a).

explicit announcements of actions) from those who have a central role in policy making have little permanent effect. The remark moved the market only slightly -- a downward blip that lasted no more than a couple of days, with no discernible effect thereafter.<sup>18</sup>

Almost all information gets revealed eventually. The issue whether it is revealed in “big” packages or slowly along the way. As I suggested, the former strategy may indeed create more instability than the latter.

*Proposition 4 for a better government: Government should encourage the private provision of public goods, including through non-governmental organizations, not only as mechanisms for the creation of effective competition to itself, and therefore putting discipline on itself, but also as an effective way of conveying voice.*

Earlier I argued that there should be a strong presumption in favor of actions which promote competition and against those which restrict competition. This commitment to competition should extend to the political arena as well. Actions which increase participation in the political process should be encouraged, those which decrease it should be discouraged.

One of the reasons that I have so strongly opposed secrecy in government is that it increases the barriers to *effective* participation in the political process. More generally, the large natural barriers to entry limit the effective competition in expression of citizens' interests and contribute to the power of narrow interest groups. The size of the national polity and the automatic membership in the state prevent the use of exit and choice to convey information.<sup>19</sup> As I noted before in my discussion of government failures, there

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<sup>18</sup> I sometimes joke that the announcement of my leaving the chairmanship of the Council of Economic Advisers had a larger and longer effect! Of course, this also underscores the point that these market movements are as much random occurrences as anything else.

<sup>19</sup> Hirschmann (1970). On a local level, however, where citizens can move between jurisdictions, exit and choice can provide market-type signals to governments. This idea, the so-called Tiebout hypothesis, is one of the predominant rationales for decentralization. While the analogy between choices among communities, suggested by Tiebout (1956) and the choice of private goods in conventional markets is suggestive, there are fundamental differences between the two which make the *optimality* of resource allocations arising from competition among communities far less likely (or valid under far more restrictive conditions) than optimal resource allocation in purely private markets. See Stiglitz (1983).

are serious free rider problems in the expression of preferences when policy costs are diffuse and benefits concentrated. Restricted information flow further increases the costs of individuals' and diffuse groups' participation.

Government can intervene in this area to provide a public good: voice. They can take a more pro-active stance in encouraging more widespread public input on policy-making. One way of doing so is to ensure that the voices of those who come together collectively to express a view, through the myriad of non-governmental organizations which are playing an increasingly important role in our society, are heard. The distinction between rent-seeking interest groups and voice-conveying citizens is not always clear<sup>20</sup> and increasing the numbers of participants and degree of competition would ensure more balanced signals of societal preferences.

While government encouragement of NGOs would increase the extent of public participation, I know of no general propositions supporting the conclusion that, short of complete participation, those most likely to participate would be fully representative of the views of society as a whole. On the contrary, they are more likely to be the groups with the greatest degree of self-interest (to benefit greatest from particular government actions). NGOs may be more effective at conveying the intensity of feelings of certain groups within the population than in conveying a sampling of the whole population's views. While it is important for the political process to reflect the *intensity* of views of some groups, government policy making must take into account the potential non-representativeness of those most forcefully exercising "voice."

*Proposition 5 for a better government: Governments need to achieve a balance between expertise and democratic representativeness and accountability.*

Openness needs to extend to the areas which have typically been the realm of

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<sup>20</sup> In the United States, for example, the Association for the Advancement of Retired People provides a forceful expression of voice for the aged; but it is a special interest group which has impeded reformers in key public entitlement programs for the elderly, blocking reforms which are necessary for the continued fiscal solvency of the country.

experts. In order to do this, the experts have to explain themselves better (reduce the “secrecy” or “shrouding” effect of technical jargon) and also be more open to the wider political realm in order to get a sense of the kind of goals toward which they should apply their expertise.

Expertise is important. One of the widely noted limitations of participatory mechanisms (including electoral mechanisms) is that the decisions may not adequately reflect “expertise,” and as a result the decisions may not have their intended effects or may not be the most efficient way of achieving the intended objectives. For instance, lay views concerning environmental hazards are not closely linked to scientific views of the risks incurred.<sup>21</sup> If decisions about resource allocations for mitigating environmental risk were left to participatory processes, there would be a marked discrepancy between perceived and actual risk reduction.

In innumerable instances, the political process has recognized these limitations. Indeed, within the United States, the early debates about republican forms of government versus direct democracy centered on similar issues of information and expertise (though not necessarily in that language.) In the United States most regulatory powers have been delegated to an independent board, typically bipartisan, though accountable to Congress and the executive branch. Although not perfect, restrictions on communication between these boards and other government branches and limitations on movement to and from the private sector help prevent the experts from being captured by particular interests. This independence is one example of the “abstinence” strategy I mentioned in proposition 1: these are areas where rents could easily be created and the government (or at least the responsive, democratic government) has limited its role in these issues. The independent boards take on a quasi-judiciary role, though much of their work is more in the nature of delegated legislation, filling out the technical details of the regulatory framework.

Achieving a balance between representativeness and independence, however, is not an easy task. Experts - particularly the experts chosen to serve on these independent agency boards - are typically drawn from a non-representative sample. Those who are

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<sup>21</sup> Slovic, Layman, and Flynn (1993), EPA (1987).

knowledgeable about an industry are more likely to have worked in the industry. The major exception are academics. In any case, expertise creates its own biases.

Perhaps the most egregious departures from representativeness have been in the area of monetary policies.<sup>22</sup> Many countries have set up independent central banks which are only loosely accountable to elected officials. The fact that politicians are judged largely on the performance of the economy, creates a curious situation where elected, representative politicians are dependent on appointed experts. With many of the appointed representatives appointed by previous administrations, the current administrations cannot even be held accountable for the quality of its appointments. The rationale for this independence, that the setting of macro-economic policies is too important to be left to politicians, may make sense as a prophylactic for populist policies in situations where short-run economic irresponsibility is a possibility, but it is weaker in those countries where huge and persistent deficits have greatly reduced the scope for discretionary policies.

One can argue that central bank independence would be a good thing in those countries which are prone to electorally-driven spending. The facts that politicians are accountable to the economy and the electorate is relatively naive strengthen incentives for quick fixes.<sup>23</sup> But one can also say that independent central banks are not the only or even the most effective way to ensure responsible monetary policy.<sup>24</sup> There is some that voters in countries with histories of hyperinflation and unpleasant crises will vote responsibly - i.e. not push for more jobs when there is a chance for repeated inflation. (Stokes, 1996) Also, the need to maintain the confidence of international capital markets may discipline politicians.

The basic argument for more representativeness in monetary policy-making is that

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<sup>22</sup> Stiglitz (1997b).

<sup>23</sup> There is a large literature documenting the proclivity for shortsighted policies, especially when the electorate exhibits myopia, perhaps based on its lack of understanding of the long-run consequences of current policies. See, for example, Dornbusch and Edwards (1991).

<sup>24</sup> Indeed, the statistical evidence correlating independent central banks with more stable monetary policies may be as much a reflection of the fact that societies that are more concerned with inflation choose to have independent central banks, and these central banks reflect societal preferences, as it has to do with the actual effect of independent central banks. See Posen (1993). For instance, Russia had an independent central bank, which was a major source of inflationary pressures, seemingly against the will of the elected government; and India has had a long tradition of stable macro-policies without an independent central bank.

economic policy involves important choices that do not have just technical answers. Though central banks often draw heavily upon bankers for their officers and boards, central banks are not just concerned with banking. The actions they take are central for macro-economic policy, and the behavior of the economy both in the short run and the long. The central bankers typically have little knowledge of these broader macro-economic policy issues which should be their central concern. Although technical expertise is important in macro-economic policy, there are a number of trade-offs (between inflation and growth, for instance) that are a matter of values. The values - and special interests - of the banking community typically differ markedly from that of the country as a whole.

Moreover, it is striking the extent to which “expert” judgments are affected by special interests: those who have more to lose from inflation and less to lose from an increase in the unemployment rate typically see less of a trade-off (less of a gain in employment, say, from a slight increase in inflation) than those who have less to lose from inflation and more to lose from an increase in unemployment. In this case, excessive reliance on “expertise” clearly inhibits competition in the public’s expression of preferences.

While some central banks have achieved a reasonable degree of expertise in their main mission (macro-stability and growth), many (to say the least) do not even draw upon the best expertise in their economy or cultivate expertise outside the affected industries, e.g. within academia or think tanks. This is particularly the case for monetary policy, the main concern of central bankers. Indeed, central bankers typically do not have even the training that makes them suited for judging the macro-economic consequences of their policy decisions - arguably their central concern. This is a case where there may even be a conflict between the *relevant* expertise for decision making in the national interest and the expertise of vested interest groups. In any case, it is certainly the case that one could achieve a high level of expertise which was at least as high as that achieved today in many, if not most, central banks, which was more representative of the national interest and affected parties and which would combine professional judgments with *values* that are

more in accord with society as a whole. Interestingly, though greater independence of the central banks may be associated with greater stability of prices, there is little evidence that economies with more independent central banks have achieved higher levels of performance in what really matters, the performance of economic activity, either in the rate of growth or the level of economic stability.<sup>25</sup> These results should not be surprising: The banking community, overwhelmingly represented within central banks, is more concerned with price stability rather than employment stability. Thus, that they have achieved objectives more in accord with their own values and interests should not come as a surprise.

Indeed, in some cases, actions which do not reflect broader views of society can give rise to political and social disruptions which interfere with the functioning of the economy. To be sure, the “experts” entrusted with the management of monetary policy should, in principle, take the costs of those disruptions into account, even if the political and social ramifications are not expressly part of their “objective function.” Nevertheless, in many cases they do not. One might well ask why they do not. Surely, there are systematic relationships between, say, economic policies and unemployment, unemployment and the probability of disruption, and the possibility of this disruption leading to political turmoil which can seriously undermine, say, the restoration of confidence in the economy. Indeed, political officials within a country typically have a far better sense of these political consequences than do those who might fly into the country for a brief visit.

Perhaps the reason for the seeming proclivity to ignore these important dimensions is the observations made earlier and elsewhere (see Stiglitz, 1998) of the correlation between values and economic judgments: those who worried more about inflation, for instance, systematically saw a NAIRU in the United States that was higher than those who were more concerned about unemployment. This simply reinforces the conclusion of the

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<sup>25</sup> Alesina and Summers (1993). The fact that those objectives have little impact on *real* values (economic growth and stability, as reflected in real growth rates and unemployment) also shouldn't come as a surprise, given the evidence on the weak connection between the two. More generally, economic systems adapt to greater price stability, and may, for instance, undertake greater leverage, making the real consequence of any variation in inflation and nominal interest rates all the greater. See Greenwald and Stiglitz (1986).

difficulties of separating out expertise from values, and therefore reinforces the importance of achieving a degree of representativeness in boards entrusted to bringing expertise to public decision making.

### *The Propositions in Context*

The five propositions provide loose guidelines for thinking about some of the government weaknesses I mentioned in the beginning of the paper. Many of these limitations of government cannot be “solved”, but our response to them can be made more balanced.

Civil service systems, for example, represent constraints intended to ensure against the abuse of power; but those same constraints often interfere with the ability of government to hire the best people and pay them competitive wages. The problem, as I noted in my 1989 Amsterdam lecture, can be viewed as one of information: outsiders cannot tell whether the government official is paying a high wage to some employee as a) an “efficiency wage” designed to elicit better performance or lower turnover; b) because he has to attract the individual c) the employee is actually highly efficient and the wage adequately reflects marginal contribution; or d) the higher wage is simply a payoff to a friend. This last case represents a private abuse of public power; a redistribution from the taxpayers to this particular individual. In the private sector, on the other hand, if the owner of a firm decides to pay a higher wage, there is a presumption that there is a good economic rationale for doing so. In any case, when mistakes or inefficient arrangements are made, only the owner of the firm bears the cost.

Similarly, in procurement, restraints are imposed to reduce the potential abuses of power. But there are high costs to these constraints. By one estimate, the cost of making jet engines for the government are a third higher than the cost of making identical engines for the private sector, simply because the government imposes a host of regulations to ensure that it is not cheated. A high price is paid to prevent abuse.

In many of these areas, there is a sense that the government has lost a sense of

balance and is now paying too high a price for preventing abuses. The persistence of the red tape can be explained by another recognized “government failure”: politicians have a concentrated interest in ensuring that “mistakes” do not occur under their watches, while the diffuse public pays for the mistake-avoidance regulations. The reliance on processes is one way which government officials seek to avoid blame. If something goes wrong, they can at least claim that they had followed well accepted procedures. It would be nice if the electorate could commit itself to judging mistakes in a more balanced way.

Such a commitment is unlikely, however. Part of the problem has to do with Proposition 3 and provides a further argument against the excessive secrecy that cloaks so much of government decision making in so many countries. The electorate only observes outcomes and seldom has the information required to assess whether reasonable actions were undertaken. Better information - including less secrecy - might enable better judgments to be made, and thus lessen biases towards risk avoidance on the part of officials. The other part of the problem, however, has to do with the difficulty of a diverse electorate arriving at an agreement as to what constitutes “reasonable actions.”

We are discovering now is that there are less costly ways of reducing the incidence of mistakes by relying on market mechanisms. If the government contracts out its janitorial services - a form of increasing participation - it can accept the lowest bid. It then doesn't have to worry about what it pays individual janitors.

#### *Political Processes and Societal Cohesion: Consensus versus advocacy*

Most of the propositions have to do, in one way or another, with participation in decision making. Secrecy seeks to exclude all but a small group; non-governmental organizations seek to expand those actively involved; the discussion of expertise versus representativeness is a debate about the extent to which decision making should be delegated to special sub-groups within the population.

There is a related issue: the manner in which decision-making occurs, in particular whether it is a consensus-seeking or advocacy process in which one side or another wins,

can have a major impact on social cohesion and thereby affect political, social, and economic stability. Decisions arrived at through consensual processes have a higher degree of *permanence*, and a higher probability of *success*. If individuals believe that those decisions are arrived at in a fair way and believe that they have been able to participate meaningfully in the decision, they are more likely to support the decision, that is, work to make sure that it is carried out and executed in a way which maximizes the likelihood of success. By contrast, policies arrived at through an exclusionary process or an advocacy process in which the majority wins and shows little regard for the losing minority set up the opposite dynamic. Losers work to reverse the decision and will take the first opportunity that they can to vote for a change. Because a decision is more likely to be reversed if the program is a failure, they may work to undermine its success; at the very least, they will not strive to ensure that it is successful. In anticipation of this, the majority may put into place all sorts of impediments to change, impediments which may not only be directly costly, but which impede change in response to unforeseen future events.

Effective consensus processes require openness. The argument that consensus will be undermined by conflictual discussion has been put forward as a reason to suppress discourse and in extreme cases maintain secrecy, but it overlooks that fact that *competitive* advocacy processes are the best way to bring out opposing arguments and encourage a balanced consideration of policies' costs and benefits. A mark of a mature democracy is that it values and understands the importance of debate and discussions, not only before decisions are made, but after. The intent of the discussion is not to undermine the last decision, but to set the stage for the next. And in an ever changing society, there will be a "next" decision. The problems society faces are complex, and the more open discussion that occurs, the greater the chance that a better consensual decision will be arrived at, one which better incorporates the information about preferences of more citizens and one which has a deeper level of commitment of the various participants.<sup>26</sup>

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<sup>26</sup> There are some obvious exceptions to this generalization, in societies in which there are fundamental cleavages in values, where open discussion may reveal the depth of those cleavages. For the most part, however, among those committed to making democratic societies work, even the recognition of depth of those cleavages may be useful, in discouraging the majority from attempting to impose its values on the minority.

*Inclusion* is also an essential part of the consensual process. While economists have long sought policies which are Pareto improvements -- policies which benefit everyone, or at least harm no one - they have also long recognized that few changes actually benefit everyone. Changes which leave out major groups in society, however, are unlikely to receive widespread support. Thus, egalitarian policies, in which the fruits of growth are shared widely, are essential. Part of the success of East Asia is that they developed a growth strategy which was *inclusive*.

### **Concluding Remarks**

This brings me back to the theme with which I began this lecture: the lessons to be learned from East Asia, both the successes over the past three decades and the problems over recent months.

It seems that many of the factors identified as contributors to East Asian economies' current problems are strikingly similar to the explanations previously put forward for their success. Strong financial markets, which were able to mobilize huge flows of savings and allocate them remarkably efficiently<sup>27</sup>, have turned into weak financial markets which are blamed for their current problems. Addressing information problems in an effective way, including business-government coordination, were considered a hallmark of these economies' success; but this coordination is now viewed as political cronyism and lack of transparency is viewed as one of the main failings. Openness to international markets was hailed as one of the grounds of their success, yet insistence on eliminating barriers in capital and trade flows is an important ingredient in many of the IMF programs. Macro-stability including low inflation was agreed to be one of the key ingredients of the East Asian economies' remarkable performance, yet the Korea IMF program included a provision requiring the establishment of an independent central bank whose sole focus was price stability. Promoting competition, especially through export-oriented policies was hailed as one of the central pillars of their stellar performance, yet lack of competition in

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<sup>27</sup> There is strong evidence of significant correlations between the depth of financial markets and economic

the business conglomerates is seen as one of critical failings.

We seem to be ignoring the fact that this is a single crisis against a record of thirty years of remarkable growth. Although a significant setback, the current turmoil does not seem likely to permanently reverse the gains of the past quarter century. We are unjustifiably treating the occurrence of a crisis as compelling evidence of a fundamentally malfunctioning economy. No economy since the beginning of capitalism has escaped fluctuations. The historical record, in fact, shows that East Asia has had *less* such fluctuations than other parts of the world -- hardly evidence of a striking vulnerability in the economies. In the last three decades, Thailand has not had a single year of negative growth, and Korea, Indonesia and Malaysia have only had one each. In contrast, the United States and United Kingdom have had 5 years each of negative growth over the same period. History also suggests that, over the long run, East Asian governments' investment strategies were reasonably successful. Even if one accepts Young and others' growth accounting results as evidence that total factor productivity growth was not higher in Asia than anywhere else,<sup>28</sup> one has to admit that total factor productivity growth was also not lower than elsewhere. However one looks at the econometric results, it is obvious that the *government system of reallocation had managed to allocate a larger percentage of GDP investment than had been achieved anywhere else in the world without any decrease in aggregate efficiency.*

The complete transformation of public discourse on East Asia demonstrates that pundits are inclined to hyperbole and to simple explanations of complex phenomena. The reality of East Asia's past success and current turmoil is probably somewhere in between the two extremes. One can see this, for example, by examining the strident accusations of "crony capitalism." True, business-government interaction in the region (the so-called Japan, Inc. and Malaysia, Inc.) always included the danger that the fine line between consensus building and collusion, between partnership and political cronyism, would be crossed. Indeed, those concerns were one of the reasons that many of us hesitated in

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growth. King and Levine (1993), also Levine (1997) contains a comprehensive summary of recent work.  
<sup>28</sup> Young (1994) and Kim and Lau (1993). However, there are good reasons for not taking these studies seriously. Rodriguez-Clare (1993).

suggesting that other countries follow all aspects of the East Asian model. Nevertheless, *on balance*, while there may have been some misallocation of resources as a result of abuses of power, the strength of the East Asian system outweighed the risks for many years. Perhaps the gains from improved coordination exceeded the losses from misguided investments. In any case, only an ideologue would claim that *but for their system of close government and business cooperation* they would have grown even faster.

A comparison of the East Asian countries with the United States also suggests that a more balanced, broad discussion should replace the current superficial, ahistorical, coverage. I have often been struck by the similarities between the strategies pursued by East Asia and the United States, including the role that the government undertook in promoting universal education, in advancing technology, and in creating and regulating financial markets.

The governments were both involved in successful industrial policy. The U.S. government's active role in promoting economic expansion into the West, granting huge blocks of land to railroads can be seen as an early business-government collaboration. This was a collaboration which resulted in a few individuals accumulating huge amounts of wealth, with more questionable benefits to society more generally. Perhaps a less questionable policy was the U.S. government's financing of the first telegraph line between Baltimore and Washington, in 1842, an example of what today would be called *pre-competitive* innovation. Many observers also argue that a strong and effective industrial policy has been hidden in our defense policies over the half century since World War II.

In both cases, the creation of deep financial institutions has been lauded as a source of their success, but neither has been fully successful in ensuring stability of the financial sector. The United States was the first country in the world to establish a national regulator, the Office of the Comptroller of the Currency, in 1863; but this did not succeed in eliminating the relatively frequent financial panics which beset the country. And while the reforms in 1933 - including the establishing of national deposit insurance - eliminated panics, they did not eliminate crises, with the last being but nine years ago.<sup>29</sup> The current

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<sup>29</sup> And there might well have been another crisis after 1989, had the United States not had the good fortune of

crisis in East Asia reinforces the necessity of government taking a large role: financial sector problems can give rise to systemic effects, with significant adverse effects on the entire economy.

Though there are many similarities in policies in the United States, there were also differences, of course, with policies pursued in several East Asian countries. Apart from its promotion of universal education and the opportunities afforded by the opening up of the West, the United States did little to promote a more egalitarian distribution of income. To be sure, American mythology emphasized the Horatio Algers of the world, but the reality may have been closer to that portrayed in Harrington's *Other America*. Many East Asian countries took deliberate measures - such as land redistribution and wage compression - to increase the degree of equality and reduce the most obvious manifestations of inequality. I have already referred to their success in reducing poverty. East Asia, contrary to the predictions made by Kaldor and Kuznets, showed that development could occur without high levels and marked increases in inequality.<sup>30</sup> It succeeded in rapid development with levels of inequality that were comparable to, and in some cases is lower than those in the United States.<sup>31</sup> These egalitarian policies brought with them a sense of inclusion and a degree of political and social stability so necessary for successful economic growth.<sup>32</sup>

In this more balanced perspective, we can see both strengths and weaknesses of government intervention. We can better identify the specific problems which have

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falling long-term interest rates in 1993, a result of deficit reduction. Given the excessive holding of long-term government bonds (a result of a misguided regulatory policy which treated these long-term bonds as safe assets, in spite of the obvious capital asset risk) had a budget deal not been made, interest rates are likely to have soared, and banks would have found themselves without adequate net worth. Would the United States then have been accused of lack of regulatory transparency or of political cronyism, as a result of the close connections between the regulatory authorities and the banking community which may well have induced this misguided regulatory policy? For a more extensive discussion, see Stiglitz (1997b).

<sup>30</sup> Kaldor (1963) had argued that high levels of inequality were necessary to generate high levels of savings. East Asia showed that even the relatively poor could save at high rates, provided there was the right institutional structure. Japan, for instance, created postal savings banks, providing a safe and convenient vehicle for financial savings. Kuznets (1955) posits that inequality will rise and fall in a U-shaped pattern during development.

<sup>31</sup> The average US Gini index for 1947-1991 is 35.28, barely below the 36.18 average of the much faster-growing East Asian economies. Taiwan (Province), China, Indonesia, Japan, and Korea, in fact, had lower average Gini indices (thus less inequality) over approximately the same period. (Deininger and Squire, 1996).

contributed to the East Asian turmoil without overshooting and condemning the role of government altogether. It is interesting to note that some of the current failures seem to be a result of governments discontinuing some of the activities that had ensured their growth over the past three decades. Thailand, for example, had a sound bank regulatory system which restricted lending to real estate. The government both realized the vulnerability that this lending created and believed that directing credit away from speculative real estate and towards more productive plants and equipment was an essential part of an effective growth strategy. These restrictions were eliminated, however, under the influence of those who claimed that such restrictions interfered with economic efficiency. Thailand's response to demands for financial market liberalization was not accompanied by an equal emphasis on strengthening regulatory/ supervisory structures. It seems fairly clear that too little government, not too much, was the problem.

Some journalists and even economists have suggested that not all proposed reforms are germane to the crisis. Some, such as Martin Feldstein<sup>33</sup>, have explicitly addressed this issue. For instance, it has been suggested that Korea alter its monetary policy to focus exclusively on price stability. Including such reforms seemed unnecessary in Korea, a country which had not even had a history of high inflation, and indeed, in which inflation in the past year had been brought down from 5-1/2 to 4 percent. One may recall that in the United States there were earlier vehement public and, I think, effective, arguments against the proposed reforms to change the Federal Reserve's mandate to an exclusive focus on price stability. Feldstein has argued that going beyond measures that are directly related to the crisis and into matters which reflect social values represents an intrusion into democratic processes which may even be counterproductive for the reform process. By contrast, ongoing dialogue redefining programs in light of changing circumstances may enhance credibility and support within a country. If my earlier analysis on the importance of consensus formation has any modicum of truth, major reforms are unlikely to be achieved or maintained without social consensus and a policy of open debate.

It also seems clear, however, that lack of transparency contributed both to the

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<sup>32</sup> World Bank (1993), Birdsall and Sabot (1993), Campos and Root (1996).

vulnerability of the financial system in East Asia and the magnitude of the downturn. In the midst of growth euphoria, accounting details might be ignored, but in the midst of a crisis, they become central.<sup>34</sup> High debt equity ratios may, for a time, fuel rapid economic growth by allowing the economy to expand without the deeper institutional infrastructure required for robust capital markets. As we have seen in recent experience, they can also make countries more vulnerable to shocks. The fact that the private sector opted for these risky conditions, chose to ignore accounting details and have high debt equity ratios is not, however, the result of government intervention. These choices, like the decisions made in Bangkok and in Dallas to invest excessively in commercial real estate, were made by individual firms.

But these private decisions were nonetheless affected by government: governments failed to provide an adequate regulatory structure for banks<sup>35</sup> that included regulations providing appropriate risk assessments of highly indebted firms<sup>36</sup> and restricting excessive real estate lending,<sup>37</sup> they failed to put into place the legal and regulatory structure required for vibrant capital markets (including protection of minority shareholders and the kinds of protections provided by the Securities and Exchange Commission)<sup>38</sup> they did not to encourage or enforce effective accounting standards,<sup>39</sup> and they did not take

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<sup>33</sup> Feldstein (1998).

<sup>34</sup> Transparency was important partly because lenders could not distinguish between good and bad borrowers, and thus withheld credit from all borrowers. But one has to keep a perspective on this as on other issues: the last set of financial crises occurred in Scandinavia, a set of countries with the general reputation of having the “cleanest” governments with the highest degree of transparency.

<sup>35</sup> Though here too one must keep one’s perspective: if one criticizes banks in the affected countries for making bad lending decisions, equal fault must be assigned to the banks and regulatory authorities in the developed countries. These banks presumably had better risk management systems, and these loans were more frequently marginal loans, added on to the debt that the companies had previously accumulated from domestic borrowers. While the systemic risk of these loans to the lending countries is no doubt less, the fact that several of the major lending countries urged international actions can best be justified as a reflection of a judgment of a broader systemic risk.

<sup>36</sup> But again, the mistakes of Asia need to be put in perspective: as I noted above, the risk assessments employed in the United States clearly did not reflect the asset value risk associated with long-term government bonds.

<sup>37</sup> Indeed, some of the countries had had more effective regulations, which were rolled back under pressure for financial sector liberalization, under the argument that these restrictions interfered with the efficient allocation of resources.

<sup>38</sup> Though, to be sure, many developed countries still do not have adequate protections.

<sup>39</sup> In the United States, accounting standards are set by the private sector, not the government; but fraud, disclosure, and other protective laws have provided a strong impetus for their widespread adoption.

actions to mitigate the systemic risks that these private decisions can lead to.<sup>40</sup> One can also accuse the United States, European, Japanese, and other creditor country governments of being lax in their duties. The East Asian governments did not force banks in these countries to make the incremental loans that further increased East Asian firms' debt-equity ratios. In short, governments' omissions, more than commissions<sup>41</sup> appear to account for the current problems in East Asia.

To be sure, governments in East Asia have not followed all of the maxims I have listed as part of good government. They promoted competition in some areas, but restricted it in others. Export sectors were competitive, but non-traded sectors often were not. Leaders promoted dialogues and consensus in some areas, but did not have sufficient transparency and openness in others. The checks and balances which reduce the likelihood of abuses were in some cases absent and in others, muffled. The balance between consensus and advocacy may have been tilted too far in one direction. Nevertheless, these circumstances are changing even in the midst of crisis. Korea, for example, had its first democratic transition of power after an open election with an active debate on key issues. Consensus on a wide set of reforms supported quick enactment of legislation.

These problems, as well as the enormous successes over the preceding three decades, provide a framework for re-examining the role of the state, for re-asking the questions, not only of what the government should be doing, but also how it should do it, and perhaps most importantly -- and most durably -- how *these* decisions are made.

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<sup>40</sup> Again, many of the countries have been subjected to pressure to reduce interventions that were designed to or had the effect of mitigating these risks. These policies are now being looked at in a far more favorable light.

<sup>41</sup> To be sure, certain government policies contributed to the problem: the seemingly pegged exchange rates in several countries may have contributed to a perception of less exchange rate risk associated with foreign borrowing than there really was. But one must not confuse policies which may be misguided with policies which underlie the current crisis. While government decisions to undertake a particular industrial project may or may not be misguided, such decisions probably played a second order effect in exposing the country to the current vulnerabilities.

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