

Second-best economic policy for a divided government

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Abstract

Economic policy advice is often dispensed based on a model of a unified, benevolent government. For some transition economies, this model is inappropriate and can lead to bad advice. The more appropriate model – that of a badly divided government – often leads to very different policy recommendations. We illustrate this point using the example of pre-privatization restructuring of state firms, and discuss its implications for foreign economic assistance.

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1. Introduction

Much economic policy advice dispensed by professional economists as well as International Financial Institutions, such as the World Bank, speaks in terms of policies that should be undertaken by ‘the government’. ‘The government’ must liberalize prices, reduce inflation, establish the legal system, restructure firms, reduce employment at the state railroad, tax oil and gas more heavily, regulate natural monopolies, etc. The makers of these recommendations realize that ‘the

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government' is at best an approximate concept. In many transition as well as developing economies, 'the government' consists of a number of ministries, each of which has its own specific objectives different from those of other ministries in 'the government'. Moreover, these objectives only rarely coincide either with public welfare, or even with the interests of the few reformers in the government who try to implement market reforms (to appeal to their own political constituencies). More typically, the various ministries pursue highly inefficient policies toward the sectors of the economy they control, as well as endeavor to undercut the policies of other ministries with which they compete.

Despite the realization that governments are often deeply divided, economic advice and assistance often do not properly account for this critical element of reality. Part of the problem is the continued use of the model of a unified, benevolent government by many economists and advisors. Part of the problem as well is the organization of some aid agencies, which results in support of many policies and projects that are counterproductive to reform. A clearer recognition of the realities of badly divided government would improve the quality of advice, as well as, perhaps, pave the way to reorganization of development assistance.

Section 2 of the paper begins with a short description of a badly divided government. Section 3 then shows how an inaccurate model of government can give rise to poor policy advice using the example of the restructuring of state firms, including natural monopolies, before privatization. The commonly made case for such restructuring is based on the model of a unified, benevolent government. In contrast, the case for rapid privatization and delayed regulation is much stronger when the government is deeply divided. In Section 4, we argue that foreign aid to Russia and other countries is often based on an inaccurate model of government, and perhaps even more important, the very institutional organization of aid agencies is often detrimental to effective delivery of assistance. In sum, we believe that failure to confront the fact of a badly divided government can have dire consequences for policy advice and foreign aid.

2. A badly divided government

In many countries, governments are formed as coalitions of ministers representing sharply different political interests and loyalties. In transition economies in particular, governments often include both economic reformers committed to the transition to a market economy, and representatives of industrial, military and agricultural interests whose commitment is to preserving these traditional strongholds of communist economies intact. The reformers are not necessarily publicly-spirited politicians; rather their political constituencies are often the direct beneficiaries of the economic transformation. Nor are the traditional ministries just anti-social; rather their political constituencies are the sectors of the economy, and the individuals, who lose when the market economy develops. To cut these losses,

the traditional ministers are interested in maintaining state control over these sectors of the economy, continuing the flow of subsidies to them, as well as preserving the dependency of these sectors, and of the millions of voters they employ, on the ministries and the state more generally. The political competition between the reformers and the traditional ministries manifests itself primarily in the battle over state control over various sectors. Such control keeps the traditionalists alive, and prevents the reformers from political ascendancy.

In some situations, such as Britain under Thatcher, Mexico under Salinas, Argentina under Cavallo, the Czech Republic under Klaus, Peru under Fujimori, and many countries in East Asia, the reformers have enough of a political mandate, or even dictatorial powers, to destroy the power of the traditional ministries. One strategy for doing so is tight government budgets and macroeconomic stabilization. These policies prevent the flow of subsidies to the constituents of the traditional ministries, and often destroy the ministries themselves. In other situations, such as today's Russia, Italy, or Israel, and much of Latin America for most of the last 30 years, the reformers have not had nearly as much power, and hence the flow of resources to traditional ministries (as well as, in many cases, separatist regions) continued. These economies often suffer from government deficits, rapid inflation, and large transfers of resources to unproductive sectors of the economy. These are the cases of a deeply divided government, of which Russia is only an extreme example.

The appropriate policy advice for such a deeply divided government is very different from that to a unified, benevolent government. The obvious point to notice is that the good policies cannot be viewed as those of 'the government'. Rather, they are the policies of reformers in the government, and are usually violently opposed by non-reformers, both because they typically cut the flow of money to their constituencies, and because their success allows the reformers to get ahead in the political competition.

The second point to notice is that even if the leaders of the government are 'the reformers', the policies that will be pursued by the traditional ministries that are part of the coalition are not going to be reform policies. When the government is deeply divided, it does not implement an agreed-upon set of decisions, but rather allows individual ministries to pursue their own agendas. As a result, the anti-reformist ministries pursue anti-reformist policies. When such ministries are asked to implement market reforms, they actually move their sectors away from, rather than toward, markets.

The last observation has the uncomfortable implication that certain reforms might simply not be feasible in transition economies because the control over the relevant decisions is in the hands of ministers opposed to reforms. If these ministers are charged with reforms, they will make things worse. The reforms can proceed only after these ministries are destroyed. In this respect in particular, counting on 'the government' to implement the reforms is a dangerous approach to take.

3. Restructuring state firms

Following the successful pre-privatization restructuring of several major industrial firms in Western Europe, several economists argued for pre-privatization restructuring of state firms in transition economies as well (e.g., Tirole, 1991). The argument is that ‘the government’ can use its control over state firms to put them in good shape through investment and perhaps layoffs, and then sell these firms for higher prices, much like the British government has done with British Airways. In addition, the government can break up state firms that potentially have monopoly power, and more generally produce the correct ‘industrial organization’ before privatization.

These ideas clearly depend on a model of a government that is both interested in achieving an efficient outcome and sufficiently unified to get its ministers to follow through with restructuring. Perhaps the Thatcher government in Britain is a good prototype. Unfortunately, the experience with pre-privatization restructuring is quite mixed even in economies with very strong executives, who generally control the government. For example, Lopez-de-Silanes (1994) shows that the Mexican experience with pre-privatization restructuring under President Salinas has been largely unsuccessful, with the government failing to earn an adequate return on its measures, such as debt absorption and investment. Even effective governments do not always restructure effectively.

For Eastern Europe and Russia, this model of pre-privatization restructuring is much less relevant. The vast majority of firms in the Czech Republic and Russia went through a mass privatization program anyway, in which the government played no restructuring role at all. In Poland as well, the few hundred privatizations have been liquidations to workers’ collectives, without government restructuring. In Russia, in the few cases where an attempt was made by the ministries to reorganize an industry, it was universally in the direction of increasing rather than reducing concentration and monopoly power. The ministries tried at various points to combine firms into associations, financial-industrial groups, and other entities that would first, generate monopoly profits that could be shared between the managers of the enterprises and the ministries, and second, more effectively obtain cheap credits from the state budget (Boycko et al., 1995). Such attempts were made in aluminum, coal, and oil industries, among others. Similarly, the state railroad system was divided by its ministry into regional companies, each having full control over all the railroad segments passing through the region. The result, of course, was that the regional company became a full monopolist over all the roads passing over its territory. We are aware of no case in Russia in which an efficiency-promoting restructuring of a firm or industry was implemented by a sectoral – or any other – ministry. This outcome is not surprising given that Russia has a deeply divided government, in which the industrial ministers do not share the reformers’ goal of building a market economy, but are instead committed to keeping control over their sectors.

In recent months, arguments for pre-privatization restructuring have resurfaced in Russia again, now in the specific context of privatizing so-called 'natural monopolies'. According to these arguments, the government should restructure the natural monopoly industries in a way that was attempted for example in the UK, by perhaps breaking off parts that can be broken off, and then setting up yardstick competition between units that do not even compete in the same market. In addition, before any privatization takes place, the government should establish regulatory agencies that would regulate the industry once it is privatized (e.g. Laffont, 1994). Only after these steps are completed, should privatization be contemplated. We believe that this reasoning, as before, fails to come to grips with the reality of a deeply divided government.

Let us first go through the issues, and then illustrate them with an example. First, restructuring and breaking up natural monopolies is generally contrary to the interests of their managers as well as the ministries that oversee these firms. Restructuring typically means loss of control, rents, and employment, and hence in no way helps ministries maintain command over large sectors. In a country like Britain, where the Prime Minister had enough power to impose her will, she could and did appoint new people to oversee the restructuring process. However, in a country where individual ministers got their jobs as part of a political compromise and therefore largely control their own activities, pre-privatization restructuring is unlikely to take place. In fact, Russia has seen no pre-privatization restructuring from either its gas or its railroad monopoly, both of which have remained largely state-controlled. Both of these sectors have focused largely on increasing their investment, often with costly-to-the-budget state subsidies, rather than on efficiency.

Second, the ministries that oversee state firms are not about to keep their prices down without a selfish political reason (such as the ability to get subsidies or to receive bribes for delivering scarce inputs.) They generally oppose the creation of independent regulators, which would compete with the ministries for control over firms. In fact, Russia's gas monopoly now charges commercial customers prices at or above world levels, and the railroad monopoly charges commercial customers very high prices (to subsidize passenger traffic and employment) – all under the supervision of sectoral ministries. In the meantime, the State Anti-monopoly Committee has remained largely powerless.

Since the relevant ministry is unlikely either to restructure or to control the prices of the state-owned natural monopolies, the case against privatization of these firms loses its appeal. In fact, when the reformers in the government do have enough power to privatize these firms (and perhaps even crudely break them up), the case for privatization is compelling. Privatization has several beneficial effects, including the increased likelihood that these firms get better corporate governance and management, the possibility of their using the private capital markets, the reduction of subsidies, and perhaps most important the likely demise of the ministries themselves (Boycko et al., 1995). Consistent with these arguments, the

relatively more privatized Russian oil industry appears to be taking much more radical steps toward restructuring than the relatively less privatized gas industry. Furthermore, from the regulatory perspective, it is more likely that the government will attempt to keep down the prices of private firms than of state firms, since the owners of the profits of these firms are private investors rather than the Treasury (Shleifer and Vishny, 1994). Such regulatory pressures, however, will really become effective only over time, as monopoly pricing becomes a hot political issue and future politicians make campaigns out of it. These politicians, however, are unlikely to be the sectoral ministers.

To illustrate further the nature of government-led restructuring, consider the proposal to restructure the Russian electricity monopoly, RAO EES Rossii, that has been made by the company itself and the ministry of Fuels and Energy that oversees it. RAO is a commercialized and partly privatized company, with controlling the block still owned by the government and voted by the ministry. RAO owns almost all of Russia's electric transmission lines (the grid), as well as most of its electricity generating capacity and distribution companies. However, in the process of privatization, some major regional generating and distribution companies have escaped RAO's control. RAO thus controls almost everything, but not everything, in Russia's electricity market.

RAO proposes a British-style restructuring of the electricity sector, based on the idea that RAO, by virtue of its control of the grid, will operate a competitive wholesale market for electricity. The proposal consists of three essential steps. First, to facilitate the creation of a rational industrial organization in electricity, all distribution and generating capacity that it not under control of RAO today must be immediately put under the control of RAO. Second, over a several year period, RAO and the ministry design a plan for the wholesale market, whereby certain distribution and generating companies could be administratively separated from RAO. However, to assure the integrity of the market, the generating companies would still only be allowed to sell to RAO, and distribution companies would only be allowed to buy from RAO. Third, when market conditions permit in 5 to 7 years, RAO at its discretion can sell its subsidiaries to private investors so long as these subsidiaries can fetch 'fair' prices.

A plan in which a monopoly argues for increased competition in its market should, in general, arouse some suspicion. It seems more likely that the fundamental, and perhaps final, element of the proposal is step 1: for RAO and its ministry to get control over the industry assets that escaped them at the initial privatization. The plans for future restructuring and privatization are less convincing. After all, if RAO is committed to giving up control over its generating and distribution capacity in the future, then the obvious strategy is to start by relinquishing control over some of its own assets, rather than grabbing control of the assets that have escaped. Indeed, some of the proposals for the restructuring of the electricity sector that are coming from the reformers in the government call for precisely such divestitures as a first step. In contrast, Step 1 of RAO's proposal is hard to

comprehend except as a standard effort by a monopoly to consolidate its control over the industry and increase its rents. If the reform proposal does not get enough support from a deeply divided Russian government, then the best strategy might be to accelerate RAO's privatization so as to get some of the benefits described above. Regulation and possible breakup might come later, when the political climate improves. The RAO proposal illustrates the nature of ministerial restructurings, and the radically different strategies that need to be pursued when the government is deeply divided.

4. Foreign aid

The allocation of foreign aid to countries like Russia often pays insufficient attention to the realities of divided government. As a result, assistance can be directed precisely to the members of the government whose goal is to derail economic reform. For example, in 1994, the World Bank approved a land reform loan to Russia to be administered by the State Committee on Land – an agency hostile to land privatization. The effect of this loan has been to slow down land reform, and to perpetuate several anti-reform policies of the Land Committee. More generally, aid is often used for large industrial rehabilitation projects. The economic rationale for these projects is dubious: it is not clear at all that Russia now needs to raise its oil output or electricity production, or that the problem with raising the oil output or electricity production is the lack of capital. In addition, the industries that receive the loans may well delay restructuring along market lines, since the loans enable them to survive in their post-socialist form. The largest problem, however, is that money often goes to the ministries that oppose reforms, and in fact try to strengthen the state sector – with all the subsidies and other costs to the rest of the economy this entails – at the expense of the private sector. Economic assistance, then, can serve to delay rather than accelerate economic reforms.

We can only speculate on what the origins of such counterproductive economic assistance are. Some of them probably come from the continued use of the model of a benevolent, unified government, which implies that it does not matter where in the government assistance goes. In addition, the very organization of some aid agencies is incompatible with efficient allocation of aid, probably because these agencies have historically focused on financing projects rather than promoting economic policies. The World Bank, for example, is divided into sectoral departments, each of which has as its counterpart the corresponding ministry in the recipient country. The counterpart of each department is then a ministry in the government. Unfortunately, the goal of many economic reforms is to destroy the ministries, and this goal is broadly incompatible with the organization of aid agencies which take these very ministries as the relevant clients.

The recognition that the recipient government is deeply divided has significant implications for aid. It suggests that aid should in fact be used politically, to strengthen the members of the government committed to reforms against the members of the government not committed to reforms. Under this model, what aid buys is good economic policies and not direct increases in GDP. Conditionality is as or more important as the money itself. Even small amounts of aid can make a difference if they help some members of the government to pursue reform policies, policies that a coalition government might otherwise not be able to agree to fund. A good example of this we know is the United States Agency for International Development support of the Russian mass privatization program. While the \$200 million that USAID spent was trivial relative to the size of the Russian economy, it enabled a critical reform policy in Russia – mass privatization – to go through, and thus paved the way for continued reforms. The reason this aid worked is because it was premised on the idea that the government is divided, and that the purpose of assistance is not to help ‘the government’ but rather to boost economic reforms and the reformers.

In sum, the recognition that many reforming governments are deeply divided matters a lot for the nature of advisable policies for these governments, as well as for foreign economic assistance.

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