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AGRICULTURAL COMPETITIVENESS: MARKET FORCES AND POLICY CHOICE

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*Constitutions, Institutions and the
Political Economy of Farm Policies: What Empirical Content?*

INTRODUCTION

There is a large and still growing literature on the political economy of agricultural policies. A substantial part of it, often based on the policy preference function approach or on reduced-form estimation of protection levels, abstracts from the institutional setting in which policy formation takes place, which is a major shortcoming. By contrast other papers, which are often case studies of a particular policy event, are rich in institutional details but do not seek generalization of results or identification of global patterns. An example is Orden (1994).

This paper attempts to reach a middle ground between these two types of treatment by addressing a missing and important dimension of the political economy of farm policies, namely institutions. The aim is to provide empirical content for the institutional dimensions of the political economy of farm policies. We explain the relevance and applicability of recent debates on growth, institutions and governance for the investigation of farm policy formation, proposing a simple taxonomy of institutions and governance concepts applicable to international comparative analysis of the political economy of agricultural policies. Proxies for transactions costs, openness, predictability and other institutional dimensions are suggested and evaluated.

Most available information relating to the institutional dimension is qualitative, being 'scores' or 'categorical dummies' which pigeon-hole countries. It is of course alluring to seek to parameterize institutions in the neoclassical fashion (Rausser and Zusman, 1992) but we believe this alley is not promising because it is too reductionist. The limited evidence on the interaction between farm policy determination and political systems and rights suggests that the interaction is non-linear and non-monotonic and that it exhibits discontinuities and thresholds (Beghin and Kherallah, forthcoming). For the time being, pigeon-holing is the most reasonable way to proceed. Another limitation comes from the small variation in measures when viewed over time; they are most useful for cross-section analysis or international comparison, unless the collection of long time series is possible.

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THE INSTITUTION AND GOVERNANCE DEBATE AND ITS RELEVANCE FOR POLITICAL ECONOMY

Institutions can be regarded as arrangements among economic agents to attempt to decrease the uncertainty in exchange and ownership (North, 1990). Ill-defined property rights induce opportunistic behaviour to capture residual benefits, within and outside firms (Milgrom and Roberts, 1992). High transaction costs and uncertainty result from such incomplete property rights. Hence institutional arrangements represent attempts to reduce the uncertainty in exchange, and lower transactions costs, by defining rules of the game. Good institutions and government promote exchange and the operation of market forces by securing property rights and future returns on investment, and by promoting predictable rules of law (Borner *et al.*, forthcoming; and Brautigam, 1991, survey the literature). Good governance relates to government policies and institutions which promote competitive markets and efficiency, by defining the rules of the game which allow transaction costs to be reduced and so enlarge the effective flow of goods and services.

Different concepts and corresponding institutional arrangements underlie good governance. First openness, political and economic, facilitates good governance. Economic openness is a matter of international or sectoral mobility of resources (financial and human) and of the commitment to allow market disciplines to work. Political openness refers to the contestability of political markets and of public-service provision, participation of pressure groups and transparency in the decision-making process. Strategically, openness is a commitment mechanism for good governance operating through a credible retaliation threat from private agents. Openness is facilitated by democratic pluralism, though the latter is neither a sufficient nor a necessary condition for its attainment. Openness promotes predictability and rule of the law because, in cases of bad governance, the state can be penalized through retaliation by private agents, or by international or sectoral transfer of resources and, potentially, their exit.

The rule of law is an elusive concept to capture empirically since it is a matter, not only of law and legislation, but also of their application and the common belief shared by most agents that the application takes place. Enforceability is hard to measure. In the absence of the rule of law, transaction costs rise and uncertainty increases. The rule of law raises the issue of predictability, since that is an essential characteristic of good governance; without it there is always potential uncertainty. Good governance and good rules are predictable.

The developing debate on governance and institutions has direct relevance to farm policies, since most of the issues discussed apply to agriculture and agricultural policy. Agricultural price policies, income stabilizing devices and measures aimed at expanding output depend on political institutions and their quality. Policy formation is influenced by the political setting, voting rules, lobbying costs and lobby group access to the political body. Furthermore, once policy decisions are made, credible implementation has to occur. Land tenure policies, which define property rights in the critical agricultural input, are of particular significance, since they are so clearly influenced by political forces.

Absence of clear land rights may induce low levels of lobbying for farm policies because of their limited expected returns, though it can trigger active lobbying to define rights in the face of increasing land scarcity (*ejidos* in Mexico provide an example). Farm subsidy benefits tend to accumulate, and be reflected in, land value. Hence property rights directly influence the uncertainty relating to the benefits of farm programmes.

Policy decisions and their enforcement will depend on the quality of governance. Different political systems, and varying degrees of political openness, can affect the outcome. Uncertainty and high transactions costs decrease the benefit of rent seeking both for policy makers and for industry and interest groups. Predictable rules for rent seeking via policy formation (or even for corruption) increase the efficiency of the policy formation process (Shleifer and Vishny, 1993). Undoing bureaucracies in the circumstances of transition or structural adjustment may increase wasteful activities by decentralizing rent-seeking activities. The multiplicity of rent-seeking bureaucrats can be seen as a loss of predictability. Rule of law, openness and accountability also define and put bounds on acceptable rent-seeking practices.

Less obvious is the interaction between policy, growth and institutions. Countries with successful growth records may have had institutions which favoured pressure groups representing high-growth industries, and the protection and subsidy patterns which emerged may have reflected that correlation; it is possible that the opposite could be seen in low-growth countries. These are examples of conjectures awaiting empirical investigation.

Direction of causation and feedback effects are not always understood and the link between policy determination (a rule of the game in itself) and institutions is far from being clarified. The interaction between growth and institutions is, however, slowly being elucidated, with fallacies relating to simple interaction mechanisms being progressively debunked (Leftwich, 1994). For instance, pluralistic polity is being promoted by international agencies as a necessary factor for growth, despite the fact that the experiences of newly industrialising countries (NICs) suggest that pluralism is not a prerequisite for predictability or for legitimacy. Instead the formation of dominant coalitions of long-term growth interest groups may have produced good governance and the economic success of the countries involved (Bardhan, 1990). Similar complexity in the interaction between institutions and policy formation is likely.

In contrast with the autocratic systems of the NICs, the Western democracies, through centuries of institutional iterations, some of which may have been unintended, have refined political openness and predictability to a degree which certainly contributes to their economic success. Hence two institutional 'recipes' have produced 'good governance' when viewed against the growth objective. Similar reasoning appears to apply to the political economy of farm policies and associated rent-seeking behaviour. Predictability of policy can be achieved under different political regimes and constitutional environments. In addition, lobby group effectiveness and effort have no reason to be monotonically linked to some institutional parameter, although institutions are certainly key determinants of political economy outcomes.

Predictability is also important in the context of political economy. Pressure-group behaviour and effort differs according to predictability concerning

the way in which policy decisions are formed. In a pluralistic polity, such as that of the US farm lobby, groups expect that policy makers will respond to rewards and penalties and that, once voted, policies will be implemented and not be subject to unannounced changes. Openness also influences rent-seeking behaviour. Mobility of resources in and out of agricultural industries, as well as trade openness, constrain the behaviour of players in the political economy game.

It is difficult to say analytically what to expect from this interaction between institutions characterizing governance and political economy. Countries exhibiting good governance have not been immune from rent-seeking behaviour but tend to have efficient and price-responsive producers. Only restricted models, with limited applicability for empirical investigation, allow the prediction of the impact of a particular rule on political outcome. Examples are direct versus indirect democracy and rent seeking (Hillman, 1989) or the impact of varying resource fixity and diversification on rent-seeking incentives (Gray *et al.*, 1991). The definition of institutions can often be vague (for example, North, 1990). The general definition of rules of the game is useful for heuristic purposes but has little empirical content. Any arrangement or codified economic behaviour that decreases uncertainty, relative to ownership and exchange, potentially qualifies. A practical matter is how to approximate transaction cost and uncertainty measures for countries or industries for which data are limited. We will identify indicators of transaction costs, or of sources of cost and uncertainty, that are likely to influence the policy-formation process. Our search is not exhaustive but rather should be seen as a first iteration.

Another essential and unresolved problem is the mapping of stylized fact finding relating to institutions and political economy into practical policy prescription. This is an additional parallel between growth and political economy with respect to institutions. Democratic pluralism can be promoted as a synonym of good governance without taking into account the political background in which countries operate. It is a vacuous policy recommendation because we know, and can recognize, what good governance is when we see it, but we do not know what historical and political conditions have to be satisfied for it to be fostered, and even less what prescriptions can increase the likelihood of good governance. Hence caution should prevail in terms of institutional reform recommendations linked to rent seeking.

A TAXONOMY OF INSTITUTIONAL VARIABLES

This taxonomy lists transactions cost indicators, measures of political openness and predictability, and indicators of economic openness, including direct measures of quality of property rights. The taxonomy combines the approach of Borner *et al* (forthcoming) on openness, with some of the Foster and Beghin (1992) categories. The taxonomy is meant to be a way to organize the data and sources.

Culture-based transactions costs variables

The US Central Intelligence Agency publishes population and cultural data for most countries. The material is broken down into ethnic groups, the three largest groups being retained and expressed as percentages of total population. The data also show each country's population distribution among different religious groups: indigenous, Christian (catholic and protestant), Jewish, Moslem (shia, sunni), Buddhist and Hindu. All are again expressed as percentages of total population. The CIA material is available annually, though it exhibits little variation over time owing to the predetermined nature of the variables covered and because of time elapsing between census dates. A third type of cultural information, available from the same source, relates to languages. It indicates the existence or not of an official language, of a business language other than the official one, and of many dialects.

These three sets of cultural information can be used to construct indices of diversity to gauge the extent of impediments to exchange and the organization of pressure groups because of high transactions costs. State boundaries may not correspond to people sharing homogeneous cultural values. Cultural diversity increases the cost of political openness and lobbying because of the precedence of some cultural interest over industry or larger political objective. For the ethnic and religious data, indices can be constructed using the negative of the sum of the cross products of ethnic or religious shares and of their logarithm. For the language data two categories can be created for countries which are linguistically diverse if business and official languages are different and if many dialects exist. These predetermined variables are useful in an econometric context because they are likely to be exogenous to the political economy problem considered. Simultaneity of institutions and policies can be suspected since institutions reflect attempts to secure rights over rents or to limit opportunism. A substantial problem is that some culturally diverse countries such as the United States exhibit well integrated markets and low transactions costs associated with lobbying. Referring to North (1990), these variables could be important for studies of developing economies where exchange and contracting may be more personal and less complex and for economic activity of less complex and shorter production cycles. Modern economies have already overcome these sources of uncertainty and other measures may be more successful at approximating transactions costs.

Communication-related transaction costs

Still from the same CIA source, several proxies of communication-related transaction costs can be found and created (information concerning length of railways, highways and paved highways is available). These measures can be normalized by land and/or population. The ratio of paved to total highways provides a proxy of road quality. The number of telephones and of television and radio stations is also available for most countries. Again, normalization by population facilitates cross-section comparisons of countries. These variables may be good alternatives to farm size and dispersion. Poor communication

networks may handicap farm pressure groups seeking to overcome 'free-riding'. The World Bank provides comparable data on paved roads, telephone main lines and railroad tracks for 1960, 1970, 1980 and 1990. Primary sources are also provided.

Political openness and predictability

For political participation, the first set of measures come from Gastil (various dates). They are increasingly popular among economists because they are available for most countries and over time since 1970. The measures include two qualitative indices of political rights and civil liberties ranking countries in up to seven categories, from best to worst. Gastil also provides a classification of polities into four categories, from dictatorship to pluralistic democracy. Vanhanen (1984, 1990) offers several measures of competition and participation in political markets. Competition in elections can be expressed as the percentage of votes for parties other than the largest one, or as the percentage of total population which votes. Both measures are available in average value for 1960–69, 1970–79 and annually from 1980 to 1988.

Political uncertainty is covered in the political sciences literature, which provides several measures of political instability, all emanating from *The New York Times Index* and put together by Taylor and Jodice (1983). These measures count the number of political coups, assassinations, riots, strikes, deaths from political violence, armed attack events and political executions. Gupta (1990) reports several aggregation schemes for these measures, of which we prefer his most comprehensive index. This measure is available for more than 130 countries up to 1983, and there is an update of the Taylor and Jodice compilation to 1985 provided by Barro and Wolf (1989).

For political predictability, Borner *et al.* (forthcoming) develop an index of the political credibility of government as viewed by private firms, based on direct interviews and surveys. The index uses two criteria which indicate firms' assessment of predictability of policies and reforms, and of their expectations about implementation of announced reforms. The index exists only for 28 countries and is available for 1980–90. It is interesting because it reflects the beliefs of private agents, though its limited country coverage is a constraint.

Economic openness variables

Black market exchange rate premia are published in *Picks* (annual) which covers most countries of the world for the period 1972–88. Such premia are a good measure of the extent of government interference with market mechanisms, and serve as a yardstick for restrictions on international financial mobility. In the agricultural context, the measures are important because taxation of the farm sector through inflation and overvalued exchange rates have been important historically. Clearly, there is a danger of simultaneity bias between these proxies and other measures of farm support such as protection ratios or

producer subsidy equivalents (PSEs). Other measures indicate the degree of institutional sophistication countries have reached to reduce uncertainty in price information gathering, especially for lengthy production processes and impersonal exchanges. Included are the existence of commodity markets (Buckley, 1986) and of stock and future exchanges (The Economist Intelligence Unit, 1988) along with transaction volumes and dates of establishment.

Picks also reports several measures (in effect, dummy variables) of financial resource mobility: free ownership of foreign currency within a country; free ownership of bank balances abroad; free ownership of foreign securities and free ownership of gold. Borner *et al.* (forthcoming) suggest the use of foreign direct investment as a measure of international economic openness. Investment is normally a result of successful openness and hence its use suffers from some circularity in the case of the analysis of growth, though it is more satisfactory for political economy analysis. It is also widely available for most countries over time from the World Bank (1994).

Openness regarding human resource mobility can be gauged using data published by Humana (1992). It includes a four-categories assessment of the freedom of movement in one's own country; of the freedom to leave that country; of the freedom from serfdom, slavery, forced labour or child labour; and of the freedom from directed employment or work permits. The information refers to 1986 and 1984 and most countries are covered.

Uncertainty arising from unpredictable property rights is indicated by Economist Intelligence Unit (annual) information on the likelihood of expropriation of foreign investors by governments. Scores can be established, though country coverage is limited. Systematic land tenure information is difficult to find. Several authors have suggested taxonomies (Binswanger *et al.*, 1993; Bell, 1990) but we have not found scores or ratings of land right 'quality'. Typically, several land tenure systems overlap and are hybrids of the taxonomies proposed. The Economist Intelligence Unit (1994) publishes information on restriction of ownership of real estate and land by private foreign investors. Scores can be established easily, given the detailed information provided, though country coverage is limited. Other measures of the quality of property rights have been tried, but these are, in general, unreliable because of different understanding of, and values put on, the legal concepts underlying them (Borner *et al.*, forthcoming).

CONCLUSIONS

We have proposed a taxonomy of institutional characteristics of countries which are likely to have an important role in shaping the political economy of farm policies. It can be noted that systematic indicators of the nature of land tenure institutions are a potentially important element which remains missing, and it is obvious that the development of measures relating to the definition of land rights would be a valuable contribution. Empirical investigations of the interaction between institutions and political economy could start with establishing stylized facts linking institutional patterns with levels of agricultural protection, and with the nature of the distortions which exist. Some institu-

tional characteristics may matter more than others in the determination of protection level as well as in the choice of instrument. More openness may induce more transparent instruments or, to the contrary, may induce reliance on obscure and complicated programmes to conceal otherwise obvious transfers. These stylized facts should then provide substance for more conceptual work establishing causation between outcomes and institutions. Our long-term objective, as agricultural political economists, should be to identify the institutions and arrangements minimizing deadweight losses and rent-seeking opportunities, while minimizing uncertainty and securing property rights. Both empirical investigation and conceptual work are required to achieve a better understanding of the processes involved. We lack stylized facts about the quantity of resources devoted to rent seeking and influence, and how they relate empirically to institutional changes. At the same time we have to develop simple analytical models to investigate the impact of simpler institutional changes on rent seeking and distortion levels.

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