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**ZEF Bonn**

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Jean-Jacques Dethier

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Center for Development Research  
Walter-Flex-Strasse 3  
D 53113 Bonn  
Germany  
Phone: +49-228-73-1861  
Fax: +49-228-73-1869  
E-Mail: [zef@uni-bonn.de](mailto:zef@uni-bonn.de)  
<http://www.zef.de>

**The author:**

**Jean-Jacques Dethier**, Center for Development Research (ZEF), Bonn, and The World Bank, Washington (contact: [j.dethier@uni-bonn.de](mailto:j.dethier@uni-bonn.de))

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## Abstract

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This paper presents a framework for analyzing the determinants and effects of public governance and a survey of recent theoretical and empirical studies pertaining to developing and transition countries. It explains how informational, transactional and political constraints on government activity lead to trade-offs between efficiency and the extraction of rents by private firms, politicians and government agents, thus producing welfare-increasing or welfare-decreasing outcomes. It also discusses how political rules and law both constrain and facilitate economic activity.

The common feature of the studies reviewed here is their analytical approach based on incentive theory and institutional economics. Governments are not benevolent dictators maximizing social welfare, but complex governance structures characterized by agency relationships. When agency problems and political and legal institutions are taken into account, it becomes easier to understand how markets and government, acting interdependently, produce social and economic outcomes that are, in many cases, inefficient and/or inequitable. The efficiency of the use of public resources as well as their targeting is seen to depend crucially on institutional features of the state and on incentive schemes in public organizations. Reforms should concentrate not only on defining objectives, instruments and parameters of public policy (regulation, taxation and redistribution), but also on designing processes and incentive schemes in such a way that credible commitment is possible and that agents actually implement policies that maximize social welfare. It is also crucial that reforms effectively prevent rent-seeking and the capture of the state by powerful elites, whose interests are at odds with those of the general public.

Section 1 introduces the issues. Section 2 presents the analytical framework and discusses successively basic theoretical concepts (2.1); the interactions between economic, political and legal systems (2.2); the relationships between public institutions and concepts of authority (2.3); the interdependence of government and markets (2.4) and the provision of public goods (2.5). Section 3 discusses four political economy themes: first, the relationship between governance and income distribution (3.1); second, models of rent-seeking (3.2); third, how outcomes are enforced in a democracy (3.3) and, finally, sociopolitical instability (3.4). Section 4 turns to legal systems, first discussing the notion of "economic constitution" (4.1) and then issues of the "cost of rights" and the conflict between fiscal sustainability and the respect for basic rights, taking as an example constitutionally guaranteed entitlements (4.2). Three sub-sections then expand on the theme of efficient legal institutions and their role in development. The issues that are discussed are: whether formal or informal legal systems are more efficient (4.3), the meaning of the rule of law, and private enforcement of laws when there is no rule of law (4.4) and whether legal systems belonging to different 'families' are more efficient (4.5).

Section 5 reviews empirical issues in assessing the links between governance and development. First, methodological problems are addressed: data issues, choice of model, and estimation problems (5.1); then cross-country studies on governance are surveyed (5.2) and, finally, empirical research within the context of individual countries is discussed, taking as an example a study on market-preserving federalism in Russia (5.3). Section 6 provides some conclusions, including remarks on a possible research agenda (6.1) and implications for international development policy (6.2).

### Kurzfassung

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Die vorliegende Arbeit stellt einen konzeptionellen Rahmen zur Analyse der Ursachen und Wirkungen Regierungsfähigkeit (*governance*) vor, und gibt einen Überblick über die derzeitigen theoretischen und empirischen Arbeiten die Entwicklungsländer und Transformationsländer betreffen. Sie erklärt wie Informations-, Verfahrens- und politische Hemmnisse staatliches Handeln beeinflussen und zu einer Güterabwägung (*tradeoff*) zwischen Effizienz und Renten privater Firmen, Politikern und Beamten kommt, wodurch wohlfahrtssteigernde oder –mindernde Ergebnisse erzielt werden. Desweiteren wird in der vorliegenden Arbeit erörtert, wie politische Mechanismen und gesetzliche Regeln ökonomisches Handeln behindern oder fördern.

Die hier vorgestellten Beiträge verwenden die Anreiztheorie und Institutionenökonomie als gemeinsamen analytische Ansätze. Regierungen sind keine wohlfahrtsmaximierenden, gutmütigen Diktatoren sondern bestehen aus komplexen Strukturen, die durch die Beziehungen der einzelnen Teilnehmer geprägt sind. Werden Prinzipal – Agent Beziehungen in Verbindung mit politischen und juristischen Institutionen betrachtet, ist es verständlicher weshalb Märkte und Regierungen, die vernetzt handeln, teilweise ineffiziente oder ungerechte soziale und wirtschaftliche Ergebnisse erzeugen. Es wird angenommen, daß sowohl die effiziente Allokation öffentlicher Ressourcen, wie auch deren Zielsetzung entscheidend von den institutionellen Merkmalen eines Staates und dessen Anreizmechanismen innerhalb der Verwaltung abhängt. Reformen sollten sich nicht nur auf die Definition von Zielen und Instrumente öffentlicher Verwaltung (Regulierungen, Steuern und Umverteilung) beziehen, sondern auch Verfahren und Anreizmechanismen entwickeln, wodurch glaubhafte Verpflichtungen des Staates möglich sind und die Bürokraten tatsächlich eine wohlfahrtsmaximierende Politik umsetzen. Desweiteren ist es unabdingbar, daß Reformen effektiv Rent-Seeking und die Übernahme des Staates durch mächtige Gruppen, deren Interessen im Gegensatz zum Gemeinwohl stehen, verhindern.

# 1 Introduction

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Organizations providing policy advice enforced by conditional lending have been referring to governance since the early 1990s. Generally, the concept has not been properly defined and is not easy to quantify.<sup>1</sup> A proper use of public resources and donor transfers to governments of developing and transition countries appears to be indicative of good governance. Evidence links dismal growth and poverty to corruption, waste, and authoritarian practices in government. More than 15 years ago, after surveying more than a century of comparative development experience in 40 developing countries, Reynolds (1983) wrote that “the single most important explanatory variable [of development] is political organization and the administrative competence of government.”<sup>2</sup>

This paper presents an analytical framework and surveys recent theoretical and empirical studies of governance pertaining to developing and transition countries. It highlights channels through which public governance affects economic performance.<sup>3</sup>

Everyone recognizes that a government’s impact on development is not simply a function of fiscal resources, but also of a more intangible thing which one can call the quality of government. The reasons why a government is good or bad, however, are not always apparent. In the frescoes painted by Ambrogio Lorenzetti in the Palazzo Pubblico of Siena around 1340, what the viewer sees are *gli effetti del buon governo* [the effects of good government] not its causes. The latter are merely suggested by the painter by the allegories of the virtues Justice, Common Good and Concord painted on the wall of the meeting room of the city council.

Institutions, laws and decisions made by public officials — policies and regulations — define incentives for economic agents and affect the allocation of investment and public expenditure. Of the total GDP produced by a country, part is used for government expenditure. From total GDP produced by the private sector, subtract public expenditure to obtain net potential production. It is potential because of deadweight welfare losses created by taxation and rents. The resources available to government from taxation or public borrowing are used for the provision of public goods or for redistribution (transfers), or are siphoned off in the form of rents captured by agents exploiting a monopolistic position (information or discretionary power). The ‘cost of government’, including the cost of enforcing rights, is a function of the deadweight losses created by taxation and rents, of the administrative and other costs of providing public goods<sup>4</sup> and

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1 A notable exception is the study by the World Bank (1998) discussed in the conclusions. For references on international organizations, see World Bank 1994; OECD 1995; ADB 1995; EU Commission 1995; EBRD 1997 and IMF 1997. The World Bank (1994) defines governance as the “manner in which power is exercised in the management of a country’s economic and social resources.”

2 Quoted in Lin and Nugent (1995), p.2333.

3 In this paper, the terms ‘governance’ and ‘public governance’ are used interchangeably. Corporate governance issues are not discussed. A useful operational reference for the latter is OECD (1998). The terms ‘government’ and ‘state’ are also used interchangeably even though they are different concepts. As pointed out by Drèze and Sen (1995), “the state is in many ways a broader concept which includes the government but also the legislature that votes on public rules, the political system that regulates elections, the role that is given to opposition parties, and the basic rights that are upheld by the judiciary. A democratic state makes it much harder for the ruling government to be unresponsive to the needs and values of the population at large.”

4 The provision of public goods needs to be measured in terms of outcomes (such as illiteracy, infant mortality, school achievements, quality of infrastructure, etc.).



transfers, and of the productivity of transfers. Governments play an essential role in facilitating, or hindering, the growth of output in several ways, for example by improving inputs such as human capital or by increasing, through the creation of new institutions, the efficiency with which inputs are used. Government is partly endogenous to the process of economic growth. Hirschmann (1970) has shown that governments are principally disciplined by the exercise of voice, while markets create managerial discipline and induce efficiency through the exercise of choice. Consumers can choose not to consume; shareholders can sell their shares, but citizens' options in regard to public goods are more limited. Citizen preferences are not linked to taxes or revenue for public services because taxation is ultimately coercive. Government performance is induced through other channels than is market performance, including accountability, transparency, and the rule of law (Brautigam 1992). The intent of this paper is to explain how, under given historical circumstances, informational, transactional and political constraints on government activity can lead to the creation of efficient (or inefficient) incentive schemes and institutions which produce welfare increasing (decreasing) outcomes.

Public governance issues can be addressed from two different angles: first, in terms of the economic, political or sociological factors that explain why a particular government is good or bad at fostering growth or increasing living standards. Identifying the determinants of governance involves clarifying the institutional conditions under which government activity can increase efficiency or welfare. Second, in terms of the economic outcomes (for example productivity or output level, health or other standard of living indicators) which may be expected from a particular government under given conditions.

The paper is organized as follows. The next section presents the analytical framework and discusses successively basic theoretical concepts (2.1); the interactions between economic, political and legal systems (2.2); the relationships between public institutions and concepts of authority (2.3); the interdependence of government and markets (2.4) and the provision of public goods (2.5). Section III discusses three political economy themes, starting with the relationship between governance and income distribution (3.1); continuing with several models of rent-seeking (3.2) and an explanation of how outcomes are enforced in a democracy (3.3) and concluding with a discussion of sociopolitical instability (3.4). Section IV turns to legal systems. It begins with the notion of 'economic constitution' (4.1). It then discusses the issues of the 'cost of rights' and the conflict between fiscal sustainability and respect for basic rights, taking as an example constitutionally guaranteed entitlements (4.2). It goes on to examine how efficient legal systems influence development, considering whether formal or informal legal systems are more efficient (4.3), the meaning of the rule of law and private vs. public enforcement of laws (4.4) and whether systems belonging to different legal 'families'/traditions are more efficient (4.5). Section V reviews empirical issues in assessing the links between governance and development, focusing first on methodological problems: data issues, choice of model, and estimation problems (5.1), then surveying cross-country studies on governance (5.2) and, finally, discussing empirical research in a single country context using a study on 'market-preserving federalism' as an example (5.3). Section VI provides some conclusions, including some remarks on a possible research agenda (6.1) and implications for international development policy (6.2).

## 2 Analytical Framework

### 2.1. Basic Concepts

Governance is the science of government behavior and performance. The term (meaning "how an organization is governed") refers to processes that have complex historical, cultural, social and political determinants. Dealing adequately with governance requires an interdisciplinary approach. While this paper occasionally borrows from political science, law, sociology and history, it relies on the toolkit of economics to provide a coherent analytical framework for describing the determinants and effects of governance.

To explain the role of institutions in development, economic theories emphasize efficiency, while political and sociological theories emphasize the role of authority, beliefs and ideology. Issues of welfare and redistribution require both economic and political explanations.<sup>5</sup> Economic and political theories are converging as a result of the use of the paradigms discussed in this section. Combining the two approaches can yield valuable insights that help to answer political economy questions. By contrast, the convergence of law and economics appears to be very slow. Some lawyers share the same paradigms as economists but represent a tiny minority of their profession.<sup>6</sup> In fact, the two manners of reasoning may be so antithetical that they may never converge to any significant degree. Still, it appears worthwhile to combine the two in searching for explanations on how rules affect development.

Our analytical approach combines the economics of incentives with institutional economics.<sup>7</sup> These two approaches examine both government and markets not only from the perspective of allocating resources through prices, voting systems or discretionary power, but also from the point of view of informational advantages, incentives and rights of control over resources. There are political failures just as there are market failures, and both are rooted in the same problems: informational and transactional and political constraints on government activity. Informational constraints on organizations are of two types: moral hazard and adverse selection;

<sup>5</sup> La Porta et al. (1998) make a distinction between economic theories (which "hold that institutions are created when it is efficient to create them, i.e. when the benefits of building institutions exceed the transaction costs of doing so") and political theories (which "focus on redistribution rather than efficiency and hold that policies and institutions are shaped by those in power and to transfer resources to themselves").

<sup>6</sup> For the most part, the literature on law and economics is limited to an analysis of regulatory issues. For an overview, see Posner (1998b). Game theory provides a basis for analyzing many legal issues in a language and with tools that are familiar to economists. Baird, Gertner and Picker (1995) seems to be an important reference, but I have not had a chance to review it.

<sup>7</sup> This analytical approach is influenced by the work of many economists such as Bardhan, Laffont, North, Shleifer, Sen, Stiglitz, Tirole or Williamson who take incentives and institutions seriously and work in different fields of economics. As pointed out by Picciotto and Wiesner 1998, many economists are trying to understand institutional causality and using incentives as a basic unit of analysis. New developments in the economics of organization, information and incentives have led to a major reformulation of welfare issues, both in microeconomics and macroeconomics. Basic references are Williamson 1985; Tirole 1989; Laffont and Tirole 1993; Persson and Tabellini 1990. Hirshleifer and Riley 1992 and Salanie 1997 are theoretical overviews that are more accessible. As discussed by Tirole 1994, extending this theoretical framework to include governments as organizations is a more recent, but growing, preoccupation. Some recent papers are cited in the references. On institutions and transaction costs, the 'new institutional economics' has produced a voluminous literature. Useful surveys are Eggerston 1990; Lin and Nugent 1995; and Rutherford 1996. These two types of literature — incentive theory and institutional economics — share concerns with more traditional public finance (Jha 1998 contains a recent exposition), e.g. on the provision of public goods and on incentive problems arising from distortive taxation, and with public choice (Mueller 1989 remains the best survey), e.g. on decision-making processes relating to public goods. Recent surveys on the economic theory of politics, which has developed as a separate branch of economics and is also relevant for governance, can be found in Persson and Tabellini 1994 and Alesina & Roubini 1997.

both limit efficiency. Transactional constraints arise because contracts seldom provide for all contingencies, which must be specified, and need to be monitored and enforced. The more uncertain the future is, the higher transaction costs are likely to be. The type of governance structure, and in particular the ownership structure, matters in the presence of transaction costs.

Governance structures are characterized by agency relationships. The general idea is that the interests of the parties to a transaction are at least partially in conflict, and the agent has some action or information advantage over the principal. The standard model of operation of an agency is one where the principal devises a scheme of incentives or penalties, such that the agent's action is altered at least partially in the direction that favors the principal's interest. This typically requires a trade-off between efficiency and risk-sharing, and the result is a second-best. Agency relationships are often more complex in the political than in the economic sphere. Most important, it is not always clear who the agent is. (Dixit 1996).

In addition to informational and transactional constraints, governments face legal and political constraints. Legal and political institutions provide the rules of the game according to which individuals and organizations operate. The rules both constrain and facilitate economic conduct. Together with technology and endowments, institutions define the set of economic opportunities in a society. The constitution and laws define the mandates of specific government officials or agencies (i.e. the scope of their respective activities), the policy instruments which they are allowed to use and the procedures according to which they must operate (e.g. publicity to ensure transparency). Politics also imposes constraints. Public administrations are agents of politicians (and indirectly of voters) and are subject to capture by interest groups, which may not seek to maximize social welfare. Politicians themselves must also be given incentives to seek social welfare as they have their own objectives and are not perfect agents for voters.

Informational constraints, economic and political transaction costs and the law give rise to several forms of rents in addition to the more familiar forms of rents arising from market imperfections (monopolies, environmental externalities, etc). Rent-seeking is discussed in section 3.2. Incentive schemes are set up in order to overcome these constraints and maximize efficiency. A great variety of schemes affecting both the quantitative and qualitative aspects of economic activity are available. Generally speaking, the theory of incentives shows that there is no first-best world and that every situation will involve trade-offs. Adverse selection implies a trade-off between efficiency and ex ante rent extraction. Moral hazard implies a trade-off between efficiency and ex post rent extraction. Finally, Laffont and Tirole (1993) show that there is a trade-off between the "power" of incentive schemes and rent extraction.

Good development policy-making involves not only selecting the right policy instruments, but also designing appropriate incentive schemes and institutions such that credible pre-commitments are in place, and agents can realistically be expected to maximize social welfare.

Two paradigms are used to discuss incentive problems arising from informational, transactional and institutional constraints. The first is complete contracts. In this case, a government is viewed as a group of agents motivated by formal and well-defined incentive schemes. Agents are induced to choose desirable actions and to reveal information fully and truthfully. The second paradigm is incomplete contracting, reflecting the fact that contracts cannot provide for all contingencies. This latter paradigm probably corresponds more closely to the actual workings of

governments than does the complete-contract paradigm. In this case, a government is viewed as having control rights over several decisions. These control rights are determined by political processes and customs, and are summarized by constitutions and laws. The exercising of these control rights can, however, lead to abuse and capture. If feasible contracts are necessarily incomplete, then dispute-settlement mechanisms become very important. 'Political contracts' are notoriously incomplete since they are contingent on political promises and compromises, and on shifts in opinion.

Organizations are set up to economize on transaction costs and to overcome agency problems. The structure of organizations and the evolution of these structures should be seen as the outcome of efforts to deal with transaction costs and general problems of agency. Ex ante transaction costs are the costs of negotiating a contract, dealing with contingencies, and of safeguarding the agreement to signal credible commitment. Ex post contracting costs include misalignment costs incurred when transactions drift out of line; set-up and running costs associated with the governance structure (e.g. the costs of creating and maintaining courts, to which disputes are referred) and bonding costs to secure commitments (Williamson 1985).

There are major differences between private and public organizations, which are attributable to differences in the measurement of incentives and in their respective governance structures (Tirole 1994). Private enterprises differ from governments in the definition of their objectives, with significant consequences for incentives. While a private enterprise may be assumed to pursue a single objective, a government agency has multiple objectives. Many of those goals are hard to quantify. For example, it is not easy to measure the outcome of "promoting and developing the welfare of wage earners", which is the goal of many ministries of labor or welfare throughout the world. Second, the weights to be attached to various objectives need to be determined. Even if it is possible to measure pollution levels and the cost of their reduction, setting up an incentive scheme can be a daunting task. Often, government agencies are unique (i.e. monopolies), making it difficult to find a comparator, whereas it would be easy to compare Ford and General Motors.

The qualitative differences between corporate governance and public governance are also significant. First, owners' preferences change over time. While shareholders want their private enterprise to maximize profits consistently, the goals of a government are defined by an evolving political process. The people, i.e. the principals, have changing tastes. Inconsistency limits contractability. Second, ownership is dispersed. Political parties and interest groups coordinate subgroups of voters, but the incentives of the former need not be perfectly aligned with the preferences of their constituents. Political parties themselves evolve into principal-agent structures.

A government is not a single agent (a benevolent dictator) maximizing social welfare, as is often assumed in economic models. A government is a complex organization consisting of many officials and multiple agencies, which are often in conflict with each other. A government consists of various tiers, each having a separate mandate and authority. Inadequately coordinated decision-making can lead to costly social policies. The main prerequisites for achieving successful governmental outcomes appear to be accurate information, credible commitment, effective monitoring and enforcement. If these prerequisites are lacking, inefficiencies arise, mutual gains disappear and opportunism prevails.

Economic outcomes are measured in terms of efficiency and welfare. One basic premise is that the design of government structures impinges on economic performance. The hypothesis is that efficient governance structures, i.e. structures with low unit-costs, contribute to better outcomes (higher productivity, higher living standards, etc). Conversely, better outcomes presuppose more efficient institutions.

Judging a particular governance structure (or comparing different governance structures) requires reference to the conditions for efficiency. The concept of efficiency has been attacked from two directions. One fundamental criticism of neoclassical economics is that 'efficiency losses' in resource allocation are usually measured against hypothetical situations involving zero information costs or zero transaction costs. Demsetz (1969) was one of the first economists to point out that traditional definitions of efficiency ignore the real scarcities and costs of information, and tend to presume that people behave differently than they do. Often, presumed inefficiencies that justify intervention arise from risk aversion, uncertainty, indivisibility or moral hazard, all of which are costly to reduce. A second criticism comes from the public-choice school. In the words of Buchanan (1987), "efficiency in the allocation of resources [cannot be] defined independently of the processes through which individual choices are exercised."

As to welfare, is what a government does equitable? Is it welfare-promoting? Explaining why one structure is better than another in this regard involves making value judgements (De Alessi 1990). Note that increases in economic efficiency, reductions in transaction or production costs or increases in institutional flexibility may take place at the expense of certain groups, and that the distribution of income may be affected adversely. Saying that good governance should lead to a more egalitarian distribution of income entails a value judgment regarding distributive justice. Similarly, advocating equality of opportunity also implies value judgments.

Arrow's impossibility theorem has finalized the divorce of efficiency and welfare (Arrow 1951). The theorem proves that no process, whether political or market, will simultaneously satisfy the weak axioms of unanimity, non-dictatorship, transitivity, unrestricted domain and independence of irrelevant alternatives. One axiom at least has to be dropped. Mueller (1989) suggests dropping transitivity, i.e. dropping the search for "the" best social outcome, which amounts to imposing a requirement that the process of social choice be fair, democratic, or in accordance with a generally held value.<sup>8</sup>

This section concludes with a definitional issue: what are rights? This theme is taken up in section 4.2. Rights serve the dual purpose of safeguarding people's interests and of providing them with control over their choices. Depending on facts and circumstances, a particular right may protect interests, or choices, or both. Legal rights are those conferred by formal legal systems. The definition of rights, particularly of property rights, is important because the absence of clear rights results in socially wasteful efforts to defend ambiguous claims. Especially in the area of welfare, the definition of rights is a controversial issue. On the other hand, rights may also be invoked to limit the pursuit of economic goals, for instance in outlawing slavery.

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<sup>8</sup> For Buchanan, who is very critical of Arrow (see Buchanan 1975), it is not possible to cross the bridge from individual to social preferences. The public interest is simply equivalent to the verdict of the democratic process (see Przeworski 1991).

One can invoke rights to claim that socialism violates personal rights or condemn capitalism by saying that it violates people's right to minimum subsistence (Hausman and McPherson 1996). We are then at the frontier between right as a concept and as a justification, but the point here is that the legitimacy of particular rights — especially welfare rights such as health care — is in practice an issue of critical importance.

## 2.2. Interactions between Political, Legal and Economic Systems

To provide an intuitive understanding of governance structures and their evolution over time, this section presents a simple description of how the legal, political and administrative institutions of a state interact. This model excludes civil society.<sup>9</sup> It is considered to be an 'omitted control variable' which would be part of the error term in a regression. This description focuses exclusively on political and legal institutions and on the government *stricto sensu* as explanatory variables for growth and welfare. In a more complex representation of reality, other elements — for instance the role of political parties and the role of mass media in shaping public opinion — would also need to be modeled.

The *legal system* confers and enforces legal rights. These rights protect economic interests and are defined through a political process. The formal legal system of a sovereign authority plays a major economic role since it sets and enforces the basic rules that govern exchange, including both economic rights and those basic political rights which are prerequisite to the exercising of economic rights. However, other (informal) legal systems are also important in creating and enforcing rights as discussed below in sections 2.3. and 4.3. Legal rights are not defined abstractly, but by political actors and through a political process. The behavior of interest groups competing for particular rights (economic advantages) according to the rules of established political institutions define the *political system*. Political decisions, whether relating to design or implementation, are translated into policy and action by the *administrative system*, with a hierarchy of agents acting on behalf of principals (citizens, politicians and policy-makers). Public governance is thus characterized by agency structures. Political actors enter into conflict with their agents, who have advantages in terms of information or action concerning the operation of government.

How these systems interact and evolve over time may be viewed as a feedback mechanism between outcomes and institutions. "Starting with some existing society we could conceive of it as a structure of rules and regulations within which the members of society have to operate. Their response to these rules as individuals obeying them, produce economic results that would characterize society. As the results materialize they will stimulate the political process in society towards changing the rules of the game. In other words, the results of the individuals in a society responding in a certain way to the original rules of the game have a feedback effect upon these

<sup>9</sup> As stated in a recent EBRD report, "good governance depends on the establishment and functioning of an effective civil society. It can be argued that the latter is a key determinant of the performance of government. This term refers to a collection of institutions that are neither governmental nor private enterprise, including political parties, voluntary organizations, religious groupings and labor unions. The term may also be taken to include the media (although in many cases the media does and should consist of profit-oriented private organizations). It is civil society that helps to provide an understanding of the public interest, that can express the wishes of various groups in the population and exercise vigilance against the abuse of power. Civil society was stunted under the old regime [in former socialist countries] where such institutions were focused narrowly on the perceived interest of the state (or rather those in power)." (EBRD 1997).

rules themselves. From the point of view of economic theory and econometrics it is meaningless to consider these rules of the game, formed by the feedback effect, as independent variables. Such a view would imply, implicitly, that there is some super dictatorial power that runs economic policy and uses the response of the people in that society as information for how to maintain or change the society.” (Haavelmo [1997]).

In equilibrium, this social system will yield a particular set of rights; a particular political structure; and a particular size of government. However, to paraphrase North (1990), changes in economic interests, protected by the legal system, will induce changes in the political structure. We can examine the comparative statics properties of this social system or its dynamics over time. We can ask efficiency and welfare questions. Institutional changes and the lowering of transaction costs may be to the disadvantage of some groups and affect the distribution of rights and of welfare in the society, prompting these groups to react — in typical feedback fashion, and with an effectiveness that is a function of their power in society — and clamor for changes in their rights.

Comparing two otherwise similar countries (or a single country in two periods) confronts the researcher with the question of “why they can get stuck in two completely different institutional equilibria, one with rampant corruption or intense ethnic conflicts and the other with much less of either”, as Bardhan (1997) puts it. One need only think of Sri Lanka in the 1970s and the 1980s, of Argentina before and after World War II, of the development of Thailand compared to that of Burma/Myanmar over the last 40 years or the development of the Czech Republic compared to that of Slovakia over the last 6 years. Temporary shifts in an equilibrium may lead to permanent changes, and the country may be locked in a low-equilibrium situation. The equilibrium is also influenced by the beliefs and the expectations of the actors, and expectations (e.g. that a given group will be corrupt or violent) can become self-fulfilling and thus perpetuate violence or corruption. Finally, an equilibrium is often “frequency-dependent”, i.e. an expected gain from corruption depends on the number of other people expected to be corrupt (Bardhan 1997).

The researcher encounters not only the problem of modeling governance structures and their evolution over time as sketched above, but also several problems of data selection and measurement: how to measure the benefits and costs of institutions; how to measure the outcomes of particular policies or public goods; etc. Of immediate importance for the research strategy is the question: which variables can safely be assumed to be exogenous (or, in a time-series context, endogenous but lagged)? This and some other issues of empirical research are discussed in section V.

### 2.3. Institutions and Authority

When there are divergences between private and public interest, contracts and systems of contract enforcement are essential to ensure that welfare improvements result from interaction. These systems are the product of complex historical, cultural, political, social and economic processes. Systems observed around the world, either contemporaneously or throughout history, are not necessarily efficient. Some authors, notably Greif (1994, 1997), have related their efficiency to morality, trust and reputation. Greif distinguishes two major types of contract-

enforcement systems. The "individualist" system which prevails in Western countries is characterized by relatively low levels of personal trust associated with an integrated structure in which individuals frequently shift from one group to another, relatively high levels of general morality, an effective legal system, and the prevalence of reputation mechanisms. In contrast, "collectivist" systems prevailing in most other countries are characterized by informal contract enforcement based mainly on personal reputation and trust. The social structure is segregated in the sense that individuals interact socially and economically mainly with members of specific religious, ethnic, or familial groups. Neither the legal system nor other organizations play a large role in contract enforcement. At the same time, there is little cooperation between members of different groups, and general morality is relatively low. The costs associated with reputation-based enforcement in the individualist system are transparent. Contract enforcement requires various organizations (such as credit bureaus and trade associations) that are costly to operate. In contrast, in the collectivist system, the cost of organizations is low, and reputation and personal trust seem to provide a free lunch (Greif 1997). This highly abstract characterization of societies does not take into account the fact that many legal systems in Asia were transplanted from the West, as discussed in section IV, but makes the point that institutions and concepts of authority are closely related.

Two radically different conceptualizations of the relation between the individual and the government are the basis for economic, political or sociological theories of government.<sup>10</sup> The first view, which places the state above the citizens, considers that the ruler exercises power for his own self-interest (or that some groups take over control of the state to further their own interests). The second view considers government to be an entity carrying out "the will of the people", so that policies may be expected to reflect the preferences of individual voters.<sup>11</sup> In this second view, "a group existing by combination and unity of aim is bound to provide itself with rules; it is not necessarily compelled to surrender its will to a supreme lawgiver in order to save society from disruption. Law, in short, begins to grow as soon as society begins to grow; it is not invented and imposed *ab extra* at any specific stage of development" (Allen 1964). In jurisprudence, the sources of law may be explained by a similar opposition between one view which considers that law, in essence, is imposed upon society by a sovereign will, and another view which considers that law develops within society of its own vitality. This latter view "does not exclude the notion of enforcement or sanction by a supreme established authority. But authority so set up and obeyed by agreement is not the sole and indispensable source of all law" (Allen 1964).<sup>12</sup>

10 Major political and sociological theories of government that have influenced modern thinking include Montesquieu, Marx, Tocqueville and Max Weber. A good reference for legal theories is Allen (1964).

11 The "sovereignty and command" view has its origins in the Roman theory of the emperor and later theory of divine monarchy and has been developed into a coherent modern theory by Hobbes. In *Leviathan* [1651], he posits a society without government and without law. He then explains why individuals who value security for their life and property would agree to surrender their freedom and abide by the rule of the sovereign, even though they recognize that there are essentially no limits that can be placed on the sovereign's use of these laws for its own exploitative purposes. The "general will" view is a child of Rousseau, Locke and the Rationalist revolution, which gave rise to many of our modern ideas about economic progress and political organization. However, as noted by Allen (1964), this view of government can also be traced to the feudal notion of contract between the King and his barons, a creation of the Middle Ages. For rationalists such as Kant and Adam Smith, "Reason is the essence of being, and Liberty the essence of law", and cooperation leads to economic progress if the government acts according to reason and not arbitrarily. As the industrial revolution proceeded in the 19th century, Rationalism gave rise to more positivist and utilitarian views and, with Bentham, in opposition to Rousseau, "the individual becomes not so much an active contributor to the sum of social good as a passive recipient of benefits."



The “state above the people” view is, of course, closely related to authoritarian political regimes. Historically, outside of Europe and North America, economic growth has generally not been associated with political institutions allowing freedom and democracy. In some Asian countries such as Korea and Singapore, accelerated growth without political freedom has taken place in the lifespan of a single generation. Pistor and Wellons (1998) point out that Asian theories of law are closely related to the concept of authority and that Eastern concepts differ considerably from those in the West by allocating significant power to the ruler. This explains why, in the recent economic history of Asian countries, formal law could be ignored in practice (see section 4.3). One view, based largely on the historical record of the Asian “tigers”, argues that accelerated development requires some measure of authoritarianism, but this idea appears to lack empirical support. Alesina et al. (1996) detect no difference between the average growth rates of authoritarian regimes and those of democracies, even after controlling for other political variables. In part, this view is based on the argument that growth requires putting emphasis, in terms of macroeconomic shares, on domestic savings and investment rather than on consumption, but it also relies on the strange idea that dictators are future-oriented and have a lower discount rate than income-earning workers (Przeworski and Limongi 1993).

A more interesting notion is that only authoritarian regimes have the capacity to resist pressure groups and the politically organized civil society. Only a degree of state autonomy — as it is called in the political science literature — is capable of insulating rulers from the pressures of industrial groups, trade unions and other lobbies.<sup>13</sup> State autonomy is a concept closely related to principal-agent theory as applied to government. The threat of “autonomization of the state” (Przeworski 1991) is always present because government agents, who generally have superior information, can always act in their own interest without effective supervision by political forces (for example, police or military who monopolize the means of coercion, or corrupt administrators). However, as Bardhan (1990) points out, “it is not so much authoritarianism per se which makes a difference but the extent of insulation that the decision-makers can organize against the ravages of short-run pork-barrel politics”, and authoritarianism is neither necessary nor sufficient for this insulation. In the view of Przeworski, Bardhan and others, the state is always ready to prey on society. Dictatorships are sources of inefficiencies. To constrain officials to act in the public interest, it is necessary to have safeguards against capture, checks-and-balance mechanisms and other institutions for controlling authority.

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12 Legislation is not the only source of law, and judicial decisions often take into account customs, Common Law, etc. Even though the law of the formal legal system is under the control of the sovereign, this does not imply that only that which emanates from the sovereign is law.

13 The concept of relative autonomy of the state seems to have originated with Karl Marx, and was first introduced in the “Eighteenth Brumaire of Louis Bonaparte” [1852]. Przeworski and Limongi (1993) note that the notion of „political regime” does not capture the relevant differences between countries, but conclude that “state autonomy” also fails to capture these differences since it would involve “finding institutions that allow the government to do what it should but disable it from doing what it should not”. Such institutions do not appear to exist.

## 2.4. Government and Markets

The government-markets nexus is the “core” of the problem of economic performance.<sup>14</sup> Markets and governments are interdependent in at least three ways (Drèze and Sen 1995). First, markets can hardly function in the absence of legal enforcement of contracts and particular rights. For instance, it is intuitively clear that one major reason why markets are weak in countries such as Somalia is the breakdown of law and order. Second, the government has a major role to play in facilitating market-based economic growth, whether in dealing with skill formation in the labor force, technological externalities, or economies of scale. Third, and more controversially, the market mechanism is dependent, for its outcomes, on government action. One interpretation of the “second theorem of welfare economics”<sup>15</sup> which formed the intellectual underpinning for extensive government intervention in developing or former socialist countries (Stiglitz 1994) is that government can play a major role in redistributing endowments, for instance by instituting a land reform benefiting poor peasants. Recent developments in welfare economics have shown that issues of efficiency and distribution cannot be separated. The extent of inequality in initial endowments determines the extent to which a government has to rely on distortionary redistributive taxation to achieve a given distribution of welfare. The relationship between inequality and economic efficiency is also affected by the nature of information and incentive problems. Since monitoring is costly, incentives are necessarily imperfect and costly, and high levels of inequality generally tend to reduce efficiency.

There is no dispute that government and markets are interdependent, but there is disagreement about their respective domains and the scope of their respective activities. Dewatripont and Roland (1996) noted recently, in the context of transition countries, that there is no agreement among economists concerning what adequate government institutions for a market economy should be, but that there seems to be agreement on three major institutional issues: the need for political and institutional stability; the need to protect private property against encroachment by the state (or by a mafia) and the need to protect taxpayers against the rent-seeking behavior of pressure groups and against corruption. These issues are touched upon in sections 3.4., 4.4., and 3.2., respectively.

For developing and transition countries, there is a large amount of economic evidence on market failures, on the one hand, and on government failures in managing enterprises and reducing poverty, on the other hand.<sup>16</sup> The “Washington consensus” envisages two worldwide priorities. First, rolling back the state in specific areas: stopping subsidies to unprofitable activities; cutting excessive transfer programs and excessive public employment; terminating the role of government as the owner/manager of productive assets in most sectors and privatizing and strengthening regulation. Second, giving government a modified and renewed role in strengthening market forces, securing property and contractual rights and actively regulating monop-

14 Discussions about public governance are inextricably linked to the „state vs. market” debate. The debate has undergone a revival in recent years because of the transition of former socialist planned economies to market economies. Stiglitz (1998); Tanzi (1997) and World Bank (1997a) summarize the issues.

15 The second theorem states that any Pareto efficient allocation is a competitive equilibrium for some set of prices and some initial distribution of resources.

lies and financial markets. Concerning public goods for which private provision is possible,<sup>17</sup> the general view is that education, health and social services are under-prioritized and under-provided in developing countries, with negative effects on the enhancement of social welfare and poverty alleviation. The view of the majority is that the public sector is, in theory, better able to deliver these services, but that capture by interest groups is a major problem in the public sector. For such services, it is important to define how to measure performance (or the effort to be exerted) in those sectors and how to overcome incentive and agency issues that arise in the context of their delivery.

Rodrik (1997) has put forward an interesting hypothesis about the role of institutions that serve to mitigate social risks and the complementarity of governments and markets. He makes the empirical point that countries with greater exposure to trade, and thus to external risks, have bigger governments and that the degree of openness is a good predictor of the expansion of governments. This, incidentally, is confirmed by the recent cross-country study by La Porta et al. (1998), who find that larger governments tend to perform better. Equating size and growth of government with the provision of social insurance, Rodrik argues that elaborate social safety nets and social security systems are found in fiscally responsible countries such as Chile or Germany, which are very sensitive to exposure to external risk.<sup>18</sup> He considers that social risk-mitigating systems ensure social welfare and political stability by acting as a "shock absorber" in case of large external shocks in a rapidly globalizing economy, a view largely shared by social-democratic economists.

### 2.5. The Provision of Public Goods

The economic case for having some goods provided by private or by public organizations cannot be made if one assumes a world of complete contracts since there is no difference between state and private provision of goods and services (Shleifer 1998). Nor is it easy to make the political case for reliance on the market because corporate governance and public governance are not comparable. Even assuming that one could make a strong theoretical case for relying on public agencies for certain activities, what should one do in pathological cases? When institutions are weak, corruption rampant, laws unenforced and participation non-existent, it is hard to say whether schools, hospitals, road maintenance and garbage collection would be better managed by private individuals or by agents of the government, especially considering that the prevalence of corruption is to a large extent endogenous and depends on the existence of government regulations in the economy (Shleifer 1998). Under what conditions should the government intervene? What outcomes may be expected if a particular activity is carried out in the context of a private vs. a public governance structure?

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16 For evidence relating to poverty reduction, see in particular Drèze and Sen (1995) and Van de Walle and Nead (1995). For evidence relating to enterprise management, see World Bank (1995). Whether the privatization of public enterprises increases social welfare is the subject of intense debate, both theoretically and empirically (see Laffont and Tirole 1993).

17 Public goods are consumed non-competitively. The entire amount of A's consumption of a „pure“ public good (such as defense) enters the utility function of B. As a result, people have an incentive to understate their true preference for the public good (the so-called “free rider” problem of incentive compatibility). When the public good is impure or crowdable, such as a park or a sewerage system, there are possibilities for private provision of the public good.

18 He makes a more controversial assertion, namely that in the majority of countries (which do not have such social security systems), it is government consumption that plays the role of “shock absorber.”

The typical case for government intervention is the presence of an externality or the provision of public goods. An externality is defined as the effect of one person's decision on someone who is not party to that decision. Coase (1988) has emphasized that the existence of an externality does not imply that there is a *prima facie* case for public intervention. Internalizing externalities implies transaction costs, and whether or not government intervention is desirable depends on the conditions in the economy concerned. The only reason individuals and private organizations do not eliminate externalities is that the gain from doing so would be offset by what would be lost (including the costs of making the arrangements necessary to bring about this result). Economic policy can endeavor to ensure that individuals, when choosing their course of action, do so in a way that will bring about the best outcome for the economy as a whole. Policy may adopt any of several means to bring this about, including exhortation; changing laws or their administration; making transactions more costly by changing the requirements for making a legally binding contract;<sup>19</sup> changing penalties or by using Pigovian taxes and subsidies. The Coase solution is to solve the problem without state intervention, apart from fixing property rights, but this is not always practicable. It does not generally work for education or health.<sup>20</sup>

The financing mechanisms, the conditions under which certain types of public goods can be provided efficiently by the private sector or by the (local or central) government, and public-good decisions made through the political process (through voting in representative democracies) have been analyzed by a vast public finance and public choice literature and will not be reviewed here. This literature does not consider political transaction costs and the political conditions under which good governance is possible, which are emphasized by contract theory. Whatever type of governance structure is involved, control rights should be assigned to persons who have the requisite information and incentives and will at the same time bear the responsibility for the political and economic consequences of their decisions. In most cases, this calls for more devolution of power to local authorities. However, such assignments of control rights have widely varying efficiency and equity effects, depending on the type of public good involved, initial conditions, etc. As Bardhan (1997) points out, this calls for a more detailed theory of the state than is usually available from the old "market vs. state" debate. On the one hand, it is necessary to recognize the limitations of the state as an economic governance structure, arising from its lack of access to local information, its lack of local accountability and its vulnerability to wasteful rent-seeking processes. On the other hand, especially in poor countries, it is often desirable that the state play an active role, catalyzing the mobilization of people in participatory development and providing supra-local support of a financial and technical nature. In situations of high economic and political inequality where elites dominate local governance structures, benefits are not likely to percolate easily to the poorer (and weaker) segments of the population.

Should public goods be provided by the government or by the private sector? To what extent are market mechanisms better guarantors of efficiency and/or social welfare than political processes or deliberative government interventions? Theory provides guidelines, but the answers to these questions have to be given on a case-by-case basis. In some instances where no markets exist, market-like, non-political incentive schemes can be created to establish Pareto-

<sup>19</sup> By making X liable for any damage or loss which he causes Y to suffer, liability laws raise X's cost of consumption and ensure that the socially optimal amount of the good is consumed.

efficient outcomes. It can be shown, for example in regard to pollution rights, that market-like mechanisms are more efficient and equitable than political allocation mechanisms. In most other instances, the issue of whether market (or market-like) or political incentive schemes should be used to provide collective goods depends in large part on the characteristics of the goods (e.g. on the presence of major externalities as is the case with law and order), on the financing scheme (on taxes and subsidies) and on the regulatory environment.<sup>21</sup> There are ways to minimize social costs in cases of asymmetric information and principal-agent problems, but Laffont and Tirole (1993) show that there is generally a trade-off between the power of the incentive scheme and rent-extraction by the regulated enterprise. In some important cases, in particular education and health, political processes appear to be superior to market processes even though, in practice, superior outcomes can probably be generated by a mixture of the two (private and public) systems competing with each other in the same country or region. Of course, the political process is subject to the usual ambiguities of majority voting, rational voter ignorance,<sup>22</sup> the poorly informed nature of the electorate, and the role of interest groups and rent-seeking behaviors — factors that are of considerable importance in poor, developing countries.

A provider of public services can invest in improving the quality of service or in reducing cost, but the problem is that the quality of a service cannot be fully specified. Hart, Shleifer and Vishny (1997) develop a model based on incomplete contracts to assess the provision of public goods by private or public firms. Private providers have stronger incentives to improve the quality of service and reduce costs than do public providers. However, private providers' incentives to cut costs are too strong because they can ignore the adverse impact on quality. Hart, Shleifer and Vishny apply their theory to the private management of prisons, a controversial trend which, according to critics, has been driven entirely by ideology and politics and yields low economic benefits (Schlosser 1998). They also show that private provision is likely to work well for some public goods (e.g. garbage collection), but not at all well for some others (police and military). In the case of education, cost cutting can have a disastrous impact in terms of lowering quality, but parents' freedom to choose a school forces schools to raise their quality in order to compete, which can have a beneficial impact. This discussion about the provision of public goods presupposes that, in the country being analyzed, the government is indeed the institution that is capable of providing these goods at the lowest transaction cost. This is by no means always the case. On the contrary, in some countries and during some periods of history, the government can be a locus for inefficient activities. This is generally the case in politically polarized and ethnically diverse societies. Political polarization and ethnic fragmentation foster rent-seeking activities because the different ethnic groups find it difficult to agree on public goods. This encourages the adoption of economic policies that can slow down or retard economic policies. Easterly and Levine (1997) find empirical support for this hypothesis in African countries.

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20 For an example involving education, see Jha 1998, pp.79-83.

21 Incentive schemes such as fixed price contracts, price caps, cost-plus schemes, etc. can be classified according to whether a regulator is allowed to use transfers (subsidies or taxes). The "power" of an incentive scheme is the link between the transfer (tax or subsidy) and the cost or profit performance of the regulated sector or enterprise.

22 Voters are less aware of the costs and benefits of public goods (e.g. national health insurance) than of the costs and benefits of private goods (e.g. private health insurance) because the information costs entailed in finding out about the policy would be too high and they know that their votes would not affect the final decision.

### 3 Political Economy

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Many economists still have a tendency to view politics as a purely technical problem. Even sophisticated models “make some allowance for politics by stipulating that the government has an objective function with different weights attached to the welfare of different income groups, reflecting their different political power. [However] they do not go on to provide any positive theory of how the government would function after its formation. It is simply assumed that the government would maximize welfare, and therefore in its operational content the theory remains normative. [These models do not recognize that] policy is a process that is political at every stage — not merely the process of legislation, but also the implementation, including the choice or formation of an administrative agency and the subsequent operation of this agency.” (Dixit 1996). The new economic theory of politics<sup>23</sup> adds realism to what economists have to say about public decision-making processes by taking into account constraints on government action, in particular second-best and optimal departures from marginal cost pricing, and the recognition of informational limitations on policymakers. As discussed above, mechanisms of information transmission and coordination can be devised to minimize costs in asymmetric information and principal-agent situations. The new theory also considers the distributional effects of political institutions.<sup>24</sup> The latter provide different opportunities to particular groups and, for a given institutional change proposed by some group expecting to gain from the proposed change, one can expect that there would be losers and that political opposition will emerge. Political transaction costs and the “relative propensities of winners and losers to engage in successful collective action” (Nugent 1998) are key elements of institutional change. This section discusses four political economy issues relating to governance: (income) inequality, rent-seeking, democracy and socio-political instability.

#### 3.1. Income Inequality and Redistribution

Why have Asian economies such as Korea and Taiwan managed to do so well in terms of growth rates and social indicators over the last four decades? The governments of these countries have adopted very interventionist policies with pervasive microeconomic interventions in most sectors. Nevertheless, they managed to avoid large-scale rent-seeking, which typically accompanies these microeconomic distortions, and have thus succeeded in dramatically increasing social welfare. Several major reasons have been offered. The role of sustainable macroeconomic policies has been stressed by several observers (e.g. World Bank 1997a). Authority, discussed above, has also been used as an argument. Krueger (1993), for instance, hypothesizes

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<sup>23</sup> Persson and Tabellini (1994, Volume 2), Bernholz & Breyer (1994) and Alesina & Roubini (1997) contain surveys of these models.

<sup>24</sup> Przeworski (1991) gives a few useful examples of political institutions: first-past-the-post electoral formulas often generate “unearned majorities” of parliamentary seats out of minority electoral support; collective bargaining frameworks affect the results of wage negotiations; property laws affect the assignment of responsibility for accidental losses; rules governing university admissions determine the class composition of the student body; etc.

that accelerated growth-cum-social welfare improvements has a lot to do with strong leadership and a well-functioning bureaucracy. Rodrik (1996) agrees, but mentions that an egalitarian distribution of income as an initial condition (by the standards of the early 1960s) may also have played a role. Equality may have been conducive to better governance for three different reasons. First, these governments did not have to contend with powerful industrial or landed elites, which allowed them to maintain a degree of "autonomy". Second, the absence of major inequalities meant that these governments did not have to engage in major income-redistribution programs. Redistribution policies favor some groups in society and create vested interests which will be opposed to reform. Third, the leadership was free to concentrate on the economic goal of accumulation and did not have to supervise the bureaucracy too closely. Bureaucracies are prone to be captured by the interests which they are supposed to regulate, and those interests can then engage in rent-seeking, which discourages investment and reduces growth. The issue of rent-seeking will be dealt with in section 3.2. below.

What are the links between governance and income equality? The empirical evidence is scant.<sup>25</sup> Perotti (1996) examines the relationships between income distribution, democratic institutions and growth and concludes that there is strong empirical support for two channels: the link between income distribution and sociopolitical stability, on the one hand, and education and fertility, on the other.

Cross-country evidence shows that the 'size of government', i.e. the amount of income redistribution by the government from low-income to high-income groups, is highly correlated with per capita GDP. In the early 1990s, for instance, transfers typically accounted for 55-60% of total public spending in OECD countries, compared to 25% in sub-Saharan Africa. Low-income countries that are not former socialist economies (and for which data were reported) generally had very small current transfers.<sup>26</sup>

In the various theories that have been put forward to explain it, the size of government results from a combination of several elements: shifts in demand for government output; the costs of supplying it; the costs of registering these demands or the opposition to such growth. These different theories regarding the size of government are reviewed by Solano (1983) and Lybeck (1988), the latter focusing on empirical tests of these theories. Ten different explanations have been put forward to explain government growth.

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<sup>25</sup> Chong and Calderon (1998) look at the statistical relationship between institutional efficiency and income inequality, defined in terms of Gini coefficient or income shares. Their empirical findings are that there is a non-linear, inverted U-shaped relationship between institutional efficiency and income inequality. This suggests that, at low levels of per-capita income, increases in institutional efficiency are linked to greater inequality in the income distribution, while for richer countries, increases in institutional efficiency generate a more egalitarian income distribution. This inverted U-shaped relationship is consistent with the views of some political scientists who argue that a small degree of corruption (or, generally, institutional inefficiency) — and therefore probably a worsening of income distribution — is good for growth because it is the "oil that lubricates the machine". Chong and Calderon investigate only relative measures of inequality (Gini) or income quintiles. They do not examine the links between institutions and absolute poverty, but point out that this is a task for future research.

<sup>26</sup> By contrast, government consumption and capital spending on public goods (public investment) is much larger in developing than in developed countries. See World Bank (1997) and IMF (1998). Comparability is difficult because of differences in accounting definitions (e.g. data for China is not comparable with data for European countries because most transfers to households are embedded in enterprise accounts, not in government accounts) and because of many countries' lack of reliable data on expenditures by sub-national levels of government.

These include: inelastic demand for public services, or demand for public sector services linked to transformation of traditional society (Wagner's law); lower productivity growth in the public sector with wages increasing at the same rate in both the private and public sectors, which leads to relative price shifts (Baumol); universal suffrage (the median voter theorem; see below); the role of interest groups (see below); fiscal illusion; political cycles; the impact of parties (for the last two, see Alesina and Roubini 1997); bureaucracy; public employees as voters; and federal as opposed to centralized government structures.

The simplest and most elegant model has been proposed by Meltzer and Richard (1981). For a given tax rate and transfer rate, an individual can choose how much to work. Although transfers and taxes are exogenous for the individual, they are endogenous to the political process. Voters who do not work maximize their utility by maximizing the amount of the transfer, while voters who work will choose to minimize their tax. In this model, the tax rate is uniquely related to the transfer rate (because of a balanced budget rule) and voters have the same utility function, so that voters face a unique choice. Meltzer and Richard show that the equilibrium under majority rule exists at the tax and transfer level selected by the median voter. The growth of government in their model is explained by the combination of the expansion of universal suffrage and the increasing inequality of income distribution. They present some empirical support for their hypothesis. Interestingly, Peltzman (1980) has also proposed a theory of redistribution under representative government, using the median voter theorem, but based on increasing equality of the distribution of income.<sup>27</sup>

Theories of the redistributive democratic government — in which the growth of transfers is essentially explained by voting in a democratic context and income distribution — raise an interesting empirical question. It is not clear whether it is growing inequality or growing equality (i.e. the “rise of the middle class”) that is supposed to produce the result. Both theories have been tested and find empirical support for the hypotheses they propose. These empirical studies can also be related to the result obtained by Barro (1997a), who, using a panel study of 100 countries over the period from 1960 to 1995, finds that the share of the middle class in total income explains political freedom more than does the inequality of income distribution. Perotti (1996), mentioned above, finds no empirical support for explanations based on the effects of income distribution via fiscal policy channels, i.e. for any positive role played by redistributive policies.

In a non-democratic system, it is hard to conceive why a political elite and its allies would willingly transfer large amounts of public resources to the poor and weak segments of societies. Some minimum amount must be redistributed in order to ensure that deprivation does not reach catastrophic proportions and with a view to ensuring socio-political stability, but the equilibrium level is probably lower than in a democracy. Drèze and Sen (1995), for instance, make the point that famines do not take place in democracies.

<sup>27</sup> Peltzman's theory is based on candidates' promising to redistribute income to the advantage of those who support their respective platforms. He argues that the more equal the distribution of income is and the more bargaining strength voters have, so greater amounts are needed the more equal the income distribution is.



### 3.2. Rent-Seeking

Interest groups compete for political influence relating to decisions on the size of government and the regulation of private activities. Of the models which examine interest groups' competition for political influence, those of Becker (1983) and North (1990) have been among the most influential. These models are similar in that they both analyze interest groups purely from the perspective of redistributive gains. However, in the Becker model, "rents" (deadweight losses) result from the transfer of income (net difference between the cost of lobbying and the eventual benefit from the policy), whereas in the North model, rents result from the lobbying activity itself. The models also differ in their assumptions. North does not assume that actors know the costs and benefits of alternative choices and know how to act upon them. North believes that the main mistake of neoclassical theory is to have been misled by assumptions of perfect rationality and perfect information. The Becker model is related to, but distinct from the vast rent-seeking literature which was started by Anne Krueger (1974) and which describes the "directly unproductive activities" that the government creates by protecting a group's monopoly position to the benefit of the monopolist and to the detriment of the buyer.<sup>28</sup>

In the tradition of these earlier Becker and Krueger models, a typical model today would assume that the government maximizes an objective function  $\Gamma = W + V$ , where  $W$  is an aggregation of the preferences of several groups in the economy (for example, agricultural workers, industrial workers and capitalists) and  $V$  is motivated by presuming that the government can extract rent from one of the groups. For example, it assesses an "industrial" tax  $v$  on urban workers and capitalists.

$$V = \pi(B) v[pQ(p, w)]$$

$$\text{where } B = sL bL(p, w) + sKbK(p, w)$$

If a given government is totally altruistic, then  $v = 0$ , and if it is totally confiscatory, then  $v = 1$ .  $\pi$  is the probability that the government will stay in power, which is assumed to be an increasing function of political contributions from interest groups (in this case, labor unions and urban capitalists). The policy parameters are  $p$  and  $w$ , with the government setting  $\tau$ , the tariff on manufacturing imports, where  $p = (p^* + \tau)$ .<sup>29</sup>

This class of rent-seeking models which emphasize the role of interest groups was developed by Grossman and Helpman (1994) and has been replicated in several contexts. Bardhan and Mookherjee (1998) follow Grossman and Helpman (1996), whose model features competition among political parties and distinguishes two categories of voters, the informed and the uninformed. They then examine whether interest groups are governed by an electoral motive or by influence buying (campaign contributions, etc). They ask how contributions affect the platform

28 Rents are earnings over and above what is necessary to attract a factor into a particular use. Rent-seeking involves wasteful expenditures incurred to secure or maintain a monopoly position. Monopolies involve a loss of social welfare because monopoly pricing lowers the consumer surplus (and increases private profits) relative to competitive behavior. The decrease in surplus exceeds the increase in profits by an amount equal to the deadweight loss (Tirole 1989). Mueller (1989) describes the Becker and the rent-seeking models. The main applications of the Krueger-type rent-seeking model have been in trade policy, but Rose-Ackerman (1978, 1997) has also applied it to corruption.

29 This example is taken from Banerji and Ghanem (1997).

of political parties in equilibrium, and show that each party is induced to behave as if it were maximizing a weighted sum of the aggregate welfare of informed voters and members of special interest groups.

How does rent-seeking operate and interact with the political process in practice? One example is provided by Åslund, Boone and Johnson (1996), who analyze the political and economic transition process in former communist countries. Transition involves not only the creation of markets and new economic institutions to replace the planned economy, but also political changes to replace the hegemony of the communist party.<sup>30</sup> The development of private enterprises and market relations creates a demand for institutions that will defend and protect the market-based system, that is the rights of private property and the enforcement of private contracts. The creation of new political institutions provides an opportunity to “lock in” economic reforms and reduce the scope for rent-seeking, but the creation of democratic institutions may not always succeed. At the start of the reforms, the former elites —essentially public-enterprise managers, government officials and Communist Party leaders — were the most organized political group and had a clear advantage over other groups. This was mostly the case in the former Soviet Union, less so in countries such as Hungary, which had already undergone a period of “depoliticization”, thus allowing managers to focus on economic performance. Enterprise managers, government officials and Communist Party leaders were able to extract rents. The main mechanisms used for extracting rents were large credit issues, trade regulations and price regulations, which thus perpetuated a regime of distortionary policies.<sup>31</sup> Democratization changed the incentives for rent-seeking. As political leaders became more accountable for their policies in the light of free media and popular opinion, incentives to maintain distortionary policies diminished. A cross-sectional look at the recent history of these countries shows that democratization has not always successfully limited rent-seeking. In some countries of the former Soviet Union in which economic change largely preceded political change, the old elite has been successful in resisting reforms, thus thwarting the development of more political freedom.

Designing appropriate institutions is the “solution to the problem of democratization” (Przeworski 1991). For countries in transition and other countries that are going through a process of democratization, for example Indonesia today or Latin America in the late 1980s, the problem is solved if a system of institutions that engenders spontaneous compliance is in equilibrium. These are two separate issues: are any systems of democratic institutions likely to promote spontaneous, decentralized compliance once they are established? Even if self-enforcing democratic institutions can be found, however, they may not be in equilibrium because the chances of particular political forces may vary considerably under different institutional arrangements. Under a system of representative democracy, for instance, the *nomenklatura* in Russia may have very different chances and may consequently be unwilling to “play the game”.

30 At the beginning of the transition, there was no well-defined process for choosing leaders and demarcating their powers. In some countries such as Poland and Hungary, round-table discussions between reformers and the old elite were followed by elections. In others, most notably in Central Asia, the former elite simply reinforced its position after the collapse of the Soviet Union. In Russia, there was a battle for power between various factions of the elite and reformers. In terms of political institutions, there was a vacuum, and no ‘checks and balances’ existed. There were no political parties with a significant reputation; the press and media were new and had no tradition of independent reporting and the judicial system was unprepared to challenge political leaders’ abuses of power when necessary (Åslund, Boone and Johnson 1996).

31 Even though it is true that social policies often awarded generous benefits to buy popular support, it is hard to argue that the massive transfer of resources through rent-seeking was justified by this social generosity. For example, it has been estimated that a decent social safety net would have cost about 2-3 % of the Soviet Union’s GNP around 1991, while rent-seeking through highly subsidized credit policies was estimated to amount to 33% of GNP in 1992 (due primarily to hyperinflation).

### 3.3. Democracy

In a democracy (where redistribution is decided through voting),<sup>32</sup> policy-makers are subject to pressure from interest groups and might pursue opportunistic policies in order to enhance their chances of re-election. Dictators may be less subject to pressure — though that remains to be proven — but may also follow opportunistic policies if their survival is at stake.

The main criticism raised against the rent-seeking concept by neo-institutionalists is that it assumes no political transaction costs. Preferences of voters are given and exogenous to the political process. Politicians' tenure in office and the informational advantages of administrators entail no costs for citizens. There are no principal-agent incentive problems. Adjustment to equilibrium is instantaneous. In the extreme, the traditional welfare economics view considers that democracy itself, i.e. deliberating to reveal individual preferences, electing politicians, employing bureaucrats to administer policies, is a "rent-seeking" process, that is a wasteful use of resources.

This extreme view is opposed by "democratic institutionalists" such as Przeworski and North<sup>33</sup>, who counter that democratic deliberation is the endogenous change of preferences resulting from communication (i.e. preferences alter gradually as information is provided to voters by the political system). The only way to reach political decisions is to go through a process in which groups organize, pressure and influence public officials. How else would public officials know what the citizens' preferences are? Only if preferences are assumed to be fixed and the adjustment to equilibrium is instantaneous can adjustment costs be avoided. When trades are consummated out of equilibrium, someone collects rents. Moreover, there is the issue of information costs: if markets are imperfect and there is imperfect information, rents (in the public or private sector) are unavoidable. Then there is the problem of agency, i.e. how to monitor (and measure) the performance of agents. The size of government depends on the total revenues extracted from constituents less the costs of policing, monitoring and administering.

North describes the historical development of a polity with representative bodies reflecting the interests of groups capable of bargaining with the ruler, leading ultimately to modern representative democracy. North's theory incorporates redistribution conflicts, interest groups and rent-seeking behavior to explain how governments behave. In its simple version,<sup>34</sup> his model of the polity is made up of a ruler and its constituents and has two characteristic features: the distribution of marginal gains among different interest groups is determined by their relative power, and the necessity to develop agents. The model, based on neo-classical assumptions,

32 In the context of representative democracy, the interests of the interest groups may or may not be compatible with those of voters. Due to rational ignorance (i.e. given that voters have no individual influence on electoral outcomes, they do not spend time collecting information), voters may not be informed about politicians' activities. This is one of the main reasons why politics is conceptualized as a competition between politicians.

33 Here, a distinction is made between the "democratic" view (opposed to the traditional economic view that politics is just a technical problem of maximizing social welfare faced by a benevolent dictator or a technocrat who knows best) from the "individualistic" view of a Buchanan or a Rawls (whose main concern is to protect individual freedom and limit government prerogatives). The latter view is discussed in section 4.1. below.

34 The simple model of the polity becomes more complicated when representation is introduced because the representative body reflects the interests of the interest groups acting on behalf of different constituents and the interest groups' role in bargaining with the ruler. On the ruler's side, this leads to the development of a hierarchical structure of agents. Analyzing modern representative democracies is complicated precisely because they feature both a multiplicity of interest groups reflecting the concentration of voters in different locations and a hierarchical structure of agents. Note that North's model is a framework for understanding economic history and does not lend itself to the analysis of normative (policy) questions.

operates as follows. Rights and contracts are specified and enforced by political decision-making, but the structure of economic interests also influences the political structure. “In equilibrium, a given structure of property rights (and their enforcement) will be consistent with a particular set of political rules (and their enforcement). Changes in one will induce changes in the other.” (North 1990). Thus, as discussed in section 2.2., causality runs both ways.

How does representative democracy work? As described by Przeworski (1991), “Democracy is a system of decentralized strategic action in which knowledge is inescapably local.” It generates the impression of uncertainty, but actors know what is possible; the possible outcomes are already contained in the institutional framework. Przeworski uses a ‘Schumpeterian’ definition of democracy, characterizing it as a system in which one or several parties lose elections. Why then do losers comply with the verdict of democratic elections? Because they believe that the institutional framework that organizes the democratic competition will permit them to advance their interests in the future.

Democracy, by definition, is a system in which no one stands above the will of the contracting parties. However, it is important to point out that the idea of a “social contract” and the language of moral values and commitments are not necessary to understand how democracy works.<sup>35</sup> Political contracts are observed only because they are exogenously enforced or self-enforcing. Third-party enforcement does not generally lead to a stable equilibrium, i.e. stable in the sense that no player has an incentive to alter his behavior. Compliance is self-enforcing if the institutional framework is designed in such a way that the state is not a third party but an agent of coalitions of political forces. Who then guards the guardian? Those who find it to be in their self-interest.

How are outcomes enforced? How does “spontaneous decentralized self-interested compliance” work? The model of Przeworski takes into account probabilities that particular political forces attach to advancing their interests under democratic institutions. The probability depends on the specific arrangements and on the resources which participants bring to the democratic competition. Democracy is self-enforcing when all relevant forces have some specific minimum probability of doing well under the particular system of institutions. This implies that, if some important political force has no chance to win distributional conflicts and if the democracy fails to improve the material condition of losers, those who expect to suffer continued deprivation under democratic institutions will turn against them. This does not imply that democracy must have a social content in order for the institutions to evoke compliance. If democracy is a system in which outcomes appear uncertain, “social content” cannot mean prior commitments to equality, justice, welfare or whatever. Throughout the 19th and 20th centuries, various aspects of democracy (suffrage, role of political parties, etc.) have changed considerably over time and from one country to another. Section 4.4. discusses the meaning of the “rule of law” closely related to democratic ideals. Democracy has often threatened economic and political elites. Democratic procedures can threaten property; political power in the form of universal suffrage and the right to associate may be wielded to restrict property rights. On the other hand, elites have often manipulated these procedures to their advantage.

### 3.4. Sociopolitical Instability

The conditions under which democracy becomes an equilibrium of decentralized strategies of autonomous political forces are very restrictive. This is why democracy has historically been a fragile form for organizing political conflicts. A priori one expects more political instability under a democratic regime than under an authoritarian regime because the former, in most instances, grants the freedom to organize and protest.

Two different definitions of instability are considered by the theoretical and empirical literature (Alesina et al. 1996). The first defines instability as the occurrence of episodes of social unrest such as demonstrations, riots, coups d'état and political assassinations. Social unrest is viewed as an expression of the dissatisfaction of the people with the economic situation. In a context where policy-makers do not want to displease the electors, these forms of protest may affect policy-makers' decisions on economic reforms. The second definition refers to frequent changes in executive power (changes in the ruling party or in the coalition in power) by constitutional or unconstitutional means. Political instability affects growth because it increases political uncertainty, which has a negative impact on economic decisions such as investments and savings. There is a large body of literature indicating that political instability retards economic reforms. First, a high frequency of change in government makes the introduction and implementation of reforms more difficult and increases the likelihood of policy reversals. Second, governments uncertain about (the probability of) being re-appointed implement sub-optimal policies in order to "worsen" the economic situation inherited by their successor. Finally, governments constantly under the threat of losing office may be unwilling to introduce politically costly measures.<sup>36</sup>

As Alesina et al. (1996) point out, the effect of political uncertainty about changes in government is greater if political polarization is more pronounced. "Polarization" is defined in terms of the differences in economic preferences expressed by various groups and political parties. Polarization will be great if society is ethnically diverse. In highly polarized and fragmented societies, government changes may lead to radical changes in policy. Africa is a case in point. While in 1960, Africa and eastern Asia were at approximately the same level in terms of income per capita and government size, by the mid-1990s, income per capita was five times greater in eastern Asia than in Africa, and government consumption was two and a half times greater in Africa.<sup>37</sup> Easterly and Levine (1997) find empirical support for the hypothesis that ethnic fragmentation and polarization encourage the adoption of growth-retarding economic policies that foster rent-seeking activities because different ethnic groups find it difficult to agree on public goods (and good economic policies).

35 This language also has a "legalistic" version, which is frequently heard in demands that the social rights of individuals (entitlements, equal treatment, etc) must be respected, for example, the right of the homeless and other 'excluded' groups to demand housing from the French government. For a good example of this language, see Rosanvallon (1995).

36 I thank Edda Zoli for discussions on the effects of instability on reforms.

37 See World Bank (1997), p.32, and Easterly and Levine (1997), pp.1203-49.

They point out that several mechanisms analyzed by other authors to be common to ethnically diverse and polarized societies could be at work. First, a war of attrition between interest groups can delay macroeconomic stabilization (Alesina and Drazen 1991); second, since various groups do not internalize the effects of their actions on other groups, uncoordinated rent-seeking or bribe-taking worsens economic outcomes (Shleifer and Vishny 1993, Mauro 1995); third, ethnically diverse societies are empirically less likely to have political institutions that create effective checks and balances (Persson, Roland and Tabellini 1997) and, finally, polarized preferences lead to a low provision of public goods (Alesina and Spolaore 1997).

## 4 Legal Systems

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This section examines systems for creating and enforcing rights and their relationship with economic performance. Is a low-cost legal system a pre-condition for increasing productivity and social welfare? Upon first consideration, there appears to be no direct link of that nature. Even though this argument is often advanced, further consideration suggests that it requires more careful scrutiny. Anecdotal evidence shows that India, whose record on those two counts has been disappointing, has a sophisticated (though outdated) legal system and a lot of lawyers, while China, which has performed much better at least in growth terms since the early 1980s, has a legal system that is still rudimentary from the point of view of a market economy. Legal systems are discussed in terms of "economic constitution" (4.1) and the "cost of rights" (4.2). The discussion then turns to a consideration of the linkages between the *efficiency* of legal systems and economic performance from three different angles: whether formal or informal legal systems are more efficient (4.3); what the notion of the "rule of law" exactly means (4.4); and whether certain legal 'families' are more efficient than others.

### 4.1. The Economic Constitution

The function of a constitution is to provide a framework for government, including definitions of the separate tasks to be accomplished by the legislative, executive and judicial powers, and to protect individuals from possible abuses by the government itself.

Let us return to the "will of the people" view discussed in section 2.3. If agency problems did not exist, the people (or benevolent "Founding Fathers") could give themselves a constitution by using as a measure of social welfare the sum of all utilities in society and design the basic rules of the game behind a "veil of ignorance" (in Rawls' terminology), i.e. taking into account the impossibility of fully anticipating all future contingencies. The problem would simply be deciding how to delegate actual social choices (i.e. policy) to agents. But we know — at least since Montesquieu — that, in reality, individuals vested with public authority can abuse their power and that checks and balance mechanisms have to be designed to ensure a proper distribution of authority in government. Institutions develop precisely because public decision-makers cannot be trusted to implement the constitution in perfect accordance with the original intention of the Founding Fathers or of the people. The decision-makers cannot be trusted because their self-interest does not coincide with the public interest; because they have different views of social welfare than the people or because they collude with interest groups.

A constitution is necessary because pay-offs are in the future. Buchanan and the Virginia School of public choice have popularized the term "economic constitution", by which they mean the set of rules governing the making of economic policy decisions.<sup>38</sup> For the Virginia School, the outcome of any policy-making exercise is determined by the process taking place within the rules that were laid down. Buchanan searches for a perfect set of rules constraining politicians.

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38 See Buchanan's Nobel Prize lecture (Buchanan 1987). See also Buchanan and Tullock 1965; Buchanan and Tollison 1984.

This is a fundamentally different view from that held by neo-institutional economists or political scientists, for whom “the cost of transacting in even the most perfect of political markets is relatively high [so that] the political actor frequently has substantial degrees of freedom in making choices” (North 1990).<sup>39</sup> According to the latter view, “political markets”, i.e. organizational forms through which collective decisions are made, are imperfect due to information and transaction costs and the ubiquity of principal-agent problems in hierarchical organizations.

The public-choice approach is important not only because of its emphasis on the political process, but also because it draws welfare or efficiency conclusions from the existence of rules or procedures. However, welfare judgments are not about just outcomes as is the case in the tradition of normative social-welfare function maximizing, but about just procedures.<sup>40</sup> Similarly, judgments on the efficiency of a particular policy are considered meaningless because they abstract from the political and procedural context. Improvements should be sought in the rules of the game. Change the rules, and the degree of efficiency will change. Moreover, the improvements are meaningless because they have to be seen as (part of) an evolutionary process, over the lifetime of the policy.<sup>41</sup> For Buchanan, normative judgments are appropriate only when the underlying economic constitution, i.e. the set of rules governing the making of individual policies, has been determined. Buchanan and Tullock (1965) were the first authors to show convincingly that traditional welfare criteria were not appropriate. They showed that it is meaningless to talk about shifting an activity from a private to a public organization without specifying the rules for making decisions if the shift is to be made. Moreover, they showed that specific voting rules may result in “over-investment in the public sector”.<sup>42</sup> For instance, the amount of public goods provided which corresponds to the median voter’s preferred position will usually result in over-investment in the public sector.

In the literature on liberal individualism, including both the ultra-liberal view of Buchanan or Hayek and the ‘social contract’ view of Rawls, the central issue is limiting the powers of government or protecting individual freedom from government intervention. These individualistic positions involve a reluctance to make interpersonal comparisons, as it is done in welfare economics. The political theory of liberal individualism passes judgment on the legitimacy of particular institutions (Hargreaves and Varoufakis 1995). Institutions are viewed as legitimate insofar as individuals who are governed by them would have broadly “agreed” to their creation.

39 North (1990, p. 140) criticizes Buchanan for “making the state into something like a mafia—or to employ their terminology—a Leviathan. The state is nothing more than a machine to redistribute wealth and income.” However, he confuses issues of legitimacy and efficiency. He overlooks the fact that mafias sometimes displace the state precisely because they provide services similar to those performed by the state (Hay, Shleifer and Vishny 1996). Even though they are clearly not legitimate authorities, mafias have the wherewithal to provide protection or, “during the long civil war in Lebanon, managed to maintain municipal services which required overcoming free rider problems” (Hargreaves and Varoufakis 1995). North’s approach takes formal and informal constraints into account. Formal institutions such as legal rules or voting systems in corporations and democracies enable individuals to express their views and influence outcomes, but informal institutions like culture also constrain individual choices. Every kind of (costly and imperfect) processing of information by economic agents, including the models (mental constructs) which they use to process this information, needs to be taken into account.

40 Buchanan’s Leviathan model has been put forward essentially to advocate the need for constitutional limits on the sources of revenue or levels of expenditure (Mueller 1989, p.271), but the theory did not withstand the test well. Oates (1985) shows that a federalist constitutional structure has a negative, but statistically insignificant effect on GDP growth in developed countries and that the degree of centralization of tax revenue was either statistically insignificant or inversely related at both the cross-national and cross-state levels.

41 In practical terms, this issue is highly relevant when one considers welfare policies such as health care, old age pensions, etc. In the case of intergenerational conflicts (considered, incidentally, by Schumpeter to be a much bigger challenge for capitalism than conflicts between workers and management), Buchanan considers that “it is almost impossible to construct a contractual calculus in which representatives of separate generations would agree to allow majorities in a single generation to finance currently enjoyed public consumption through the issue of public debt.” (1987, p.249. See Dixit p.15)

42 Posner (1998) also considers that too much legislation and excessive investment in other public-sector activities is detrimental for growth.



This agreement, which provides the link between public-choice and contract-theoretic literature, is of course possible only in the absence of deprivation or violent threat. People who are in dire straits often "agree" to the worst possible outcome.

The recent literature on economic constitutions deals essentially with three issues: government commitment, political accountability and the "cost of rights." Recent writings on commitment and political accountability discuss how institutions can endogenously lead the government to hold its promises regarding property rights. Examples of such institutions are regulatory schemes (for telecom for instance), privatization methods or fiscal decentralization mechanisms (see e.g. North and Weingast 1989; Levy and Spiller 1996; Dewatripont and Roland 1996). This extensive literature is mentioned only in passing and will not be reviewed here.<sup>43</sup> Instead, the next section focuses on the issue of the cost of rights. Incidentally, it should be mentioned that the distinction between property rights and social rights in jurisprudence is much weaker than economists often believe.<sup>44</sup>

### 4.2. The Cost of Rights <sup>45</sup>

The cost of rights literature asks how much it costs society to protect and enforce individual rights such as habeas corpus, freedom of the press or entitlements to health care, social welfare and an old-age pension.<sup>46</sup> Public sentiment gets translated into constitutions, and constitutions often enshrine the moral values shared by the majority in founding charters even though, as Cass Sunstein puts it, "there is a big difference between what a decent society should provide and what a good constitution should guarantee". At the end of the 18th century, the United States and France, soon followed by other countries, enshrined basic rights in their constitutions. The decades since the end of the Second World War have seen a dramatic move toward the inclusion of welfare rights in constitutions. Many western European countries have moved toward the acceptance of welfare rights as constitutional rights.

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43 Many countries that recently underwent a democratization process have adopted new constitutions or amended their existing ones, for example Brazil in Latin America and the countries of eastern Europe and the former Soviet Union. Stephen Holmes and other authors have argued that transition countries need a strong executive branch that can combine effectiveness and legitimacy in a context of rapid change to meet the complex and contentious challenge of reform. They therefore advocate "stop-gap constitutionalism", i.e. interim constitutions that leave some ambiguity as to the exact rules of the game and leave enough latitude for a strong executive. They admit, however, that giving high levels of discretionary power to the state is not desirable for a constitutional order over the long term. By contrast, other authors, and most forcibly Jon Elster, have argued that the success of economic reform depends as much on "designing an effective constitution as getting the prices rights." Joel Hellman, applying regression analysis to data from post-communist countries, shows that high levels of executive power are negatively correlated with the success of economic reforms, and that the negative effects of executive power are worse in those countries which postpone the writing of their constitutions. Hellman concludes that "while not a precondition for economic reforms, constitutions do appear to contribute to the political capacity to adopt economic reform measures" (Hellman 1997).

44 Some entitlements have the same status as property in jurisprudence. Social rights are viewed either as acquired rights or as purchased rights. In countries with a code of civil law, acquired rights are generally protected under the doctrine of legal certainty (The equivalent common-law concept would be 'reliance'). Purchased rights, which are entitlements that are insurance-based, are protected in the same way that property is, applying the doctrine of public interest, implying that fair compensation is required when a person's rights are violated. In addition, all social rights are protected by the concept of non-discrimination and, in some countries, by notions of a "social minimum" guaranteed by the constitution. The latter is generally interpreted restrictively, as is the case in Germany, which means that the court implicitly recognizes the existence of fiscal and macroeconomic constraints.

45 Drawn partly from Dethier and Shapiro (1998).

46 See the recent book of Holmes and Sunstein (1999).

The German constitution, for example, states that the Federal Republic is a social state, while the constitutions of France, Italy, Japan, Spain and the Scandinavian countries all make reference to specific social and economic rights. Many eastern European countries are following in the steps of their Western neighbors. Even the US — long a staunch supporter of restricting constitutional rights to the right to be free of government intervention — has nonetheless begun to interpret positive rights as statutory entitlements rather than privileges.

How enforceable are these rights enshrined in constitutions? The enforceability of social rights and their protection by courts is obviously a central issue since a new government coming to power could easily renege on the “promises” made by its predecessor. The literature distinguishes between “negative rights” (the right to be left alone by the government) and “positive rights” (entitlements). Some authors see the main distinction between positive and negative rights in their relative enforcement costs and processes. They consider that positive rights are inevitably assigned to scarce goods, and consequently scarcity implies a limit. Negative rights do not appear to have such material limitations. Other authors disagree, arguing that enforcing negative rights is just as costly and problematic as enforcing positive rights because the appropriate amount of “forbearance” may not be present and will require legislation, which is not without cost, as well as sanctions, police, law courts and prisons in order to secure the appropriate degree of compliance with forbearance and abstinence from action.

Before the central issue is broached, a word should be said about constitutional control. This is generally entrusted to a separate instance of the judiciary system. In the American model, the Supreme Court is the final appellate tribunal and rules only on individual cases, in most instances without deciding fundamental issues. In the European model, to which both western and eastern European countries refer, the constitutional court's primary function is not to adjudicate controversies between individuals and their government, but to provide an interpretation of the constitution. The constitutional court stands apart from the rest of the state apparatus, including the judiciary, and is responsible only to the national constitution and the values it incorporates (Schwartz 1993). Constitutional control is therefore interpretive and abstract. Review by the court is abstract in the sense that the court analyzes a law or decree *per se*, and not as it applies in a particular disputed instance. This has two important implications. First, the court cannot dismiss the issue it is presented with as moot, burdening it with a heavy case load and, as Schwartz puts it, “continually plung[ing] constitutional courts into political controversies by giving standing to relatively small groups of legislators who have lost a legislative battle”.<sup>47</sup> Second, the European model gives the court a very powerful role as a social arbiter, as it is, in effect, entrusted with interpreting the letter and the spirit of the Constitution on behalf of the people. When welfare reforms are envisaged or when the executive branch proposes major changes to the legislature, the role of constitutional courts is significant. Since the court, in effect, manages the “legislatively generated expectations of the beneficiaries” to borrow Andras Sajo’s phrase, the social philosophy of the judges, i.e. the views they put forward on the extent of redistribution that should take place to insure against social risks, or to assist those in need, is crucially important.

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47 This is a major difference from US courts, which avoid ruling on abstract or moot issues (Schwartz, 1993).

One central aspect — though by no means the only one — of the cost-of-rights problem is how entitlements, once created, are to be enforced and how they can be modified when an unsustainable fiscal policy compels a government to undertake reforms. Modern democratic welfare states which have included commitments to social goals in their constitutions and have the constitutionality of their laws reviewed by courts independent of the judiciary, distinguish between enforceable negative rights and not directly enforceable positive rights. In other words, these social rights are programmatic or aspirational goals. If constitutional courts were to consider social rights to be strictly enforceable,<sup>48</sup> two consequences would ensue: reform attempts would be endlessly paralyzed, and fiscal expenditure would remain high.

The interpretation of a constitution needs to change over time to adapt to changing circumstances. Nevertheless, even though gradual interpretative changes are desirable, sudden reversals in the court's opinion or unexpected changes in the "rules of the game" induced by the court can create uncertainty in economic and social life. How are basic constitutional principles, particularly the principle of legal certainty which is the basis for the protection of acquired rights, to be reconciled with the need for policy reform? An examination of court rulings in some advanced welfare states shows that a majority of constitutional courts view this issue as an insurance problem. When these courts invoke the principle of legal certainty, they actually refer to attitudes toward risk and to different prudential aspects of policy changes. Let us compare the situation of a social security contributor faced with a change in his/her rights with that of a bondholder faced with the threat of government default on his bond; or with that of a mortgage holder/property owner faced with a change in subsidized interest rate.<sup>49</sup> How is the intertemporal perspective, i.e. the expectations of policy continuity or change, addressed in the constitution? "Backward-looking" cases involve actual or reasonable reliance (the equivalent German legal concept is *Vertrauensschutz*). Should the population have assumed that government policy would not change? For instance, should a worker near retirement who is facing a loss of expected benefits have made such an assumption in a country where the parameters of social security policy change frequently? The amount that the worker saved for retirement may have reflected an implicit government promise not to change entitlements (within certain limits). A bondholder and a property owner have a stronger claim than a social security recipient. Even though there has been a promise of general policy continuity such that contributors will later benefit, the conscious knowledge that changes in welfare policy were being discussed and implemented all the time, makes the old worker's reliance weak (and the reliance claim of a younger worker weaker still). In some other specific cases that are "forward-looking", what is involved is future expectations about policy change or continuity. There are strong arguments to protect the bondholder and the property owner. A bond default might raise the interest rate that the government must pay on its bonds for decades to come. A shift to a policy permitting expropriation might make people reluctant to invest in socially valuable ways which leave them vulnerable to uncompensated seizure. The arguments against modifying acquired social rights are weaker, however, and the offsetting disadvantages of maintaining policy continuity are strong. In yet a third type of

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<sup>48</sup> This has been the tendency of most of the new constitutional courts created in eastern Europe and the former Soviet Union, which do not seem to understand, or refuse to understand, the impact of their rulings on fiscal sustainability.

<sup>49</sup> Shaviro (1997) provides a discussion of the issues.

court rulings, the issue is actually how to compensate for welfare losses resulting from the "shock" (price increases and/or reduction in entitlements) linked to a policy change. This is essentially an issue of implicit insurance. Losses often inflict the least harm if they are spread widely, rather than being concentrated. One could argue that if people are averse to the risk of policy change, they should simply buy private insurance against it. In some areas, however, where insurance markets are not well developed (e.g. for survivorship or disability risks in transition economies), it is desirable, through government reform, to provide incentives to develop these markets to generate a different blend of private and public activities in society. For example, the Hungarian pension reform of 1997 created a publicly mandated, but privately managed retirement system.

But if private insurance markets, which tend to be more efficient, are available, should the government continue to act as an implicit insurer? In some extreme cases, policy continuity (and the strict enforcement of rights) as a form of implicit public insurance is preferable to private insurance. It can be argued, for instance, that bondholders should be repaid for pragmatic reasons. The government is its own best insurer against the risk of its reneging on its own definite commitments (Shaviro 1997). In most other cases, including welfare rights, the general tendency of constitutional courts in modern welfare societies has been to treat welfare recipients in light of their possible reliance, but to require them, if necessary, to bear some of the costs of change.

Gradual and widely expected change is preferable to sudden and unexpected change. Moreover, distributing the cost of change as widely as possible is often desirable on insurance grounds. This suggests the following conclusion: if welfare policies are unsustainable, they should be changed as gradually as possible, all else being equal. Early and more gradual policy changes will facilitate changes in expectations and behavior. In addition, in social insurance cases, this will permit the costs of change to be spread among a larger number of people. From an intergenerational perspective, policy continuity is preferable for older persons and flexibility for younger participants.

### 4.3. Formal vs. Informal Legal Systems

Posner (1998) makes the point that economic development is possible without much law at all. By this he means that, under specific economic and political conditions, an informal legal system based on custom and tradition may be better at fostering growth and stability than formal laws imposed by a self-serving ruler lacking legitimacy and enforced by corrupt judges. The relative efficiency of a legal system is determined by economic and non-economic aspects (economic transaction costs, political transaction costs). Several authors such as Milgrom, North and Weingast (1990) and Greif (1997) have pointed out that the key to facilitating trade and markets is not the coercive power of the court, but the availability of information at the level of society. The traditional neoclassical general equilibrium framework assumes that the legal system is the only relevant institution for contract enforcement. Due to asymmetric information and incomplete contracts, however, the extent to which legal systems can facilitate exchange is limited and, most of the time, this implies a loss of efficiency.

Throughout history and in contemporaneous life, one finds cases in which a loss of efficiency promotes the emergence of private institutions to govern exchange without relying directly on the legal system and to provide incentives for compliance. The formal legal system plays largely an indirect role in governing exchange. The ability and willingness of the state to provide efficient and impartial enforcement of legal contracts also substantially affect the relative efficiency of legal contract enforcement and its use. For example, if the cost of using the legal system is high, this forces the adoption of informal means to govern exchange.<sup>50</sup> As a market economy develops, traditional institutions tend to disappear and be replaced by modern institutions, though this need not always be the case (which is why, as pointed out by Greif, policies aimed at enhancing contract enforceability may be counterproductive if introduced at an inappropriate stage of development). As the market economy becomes worldwide and global, in spite of social and cultural differences, there is a process of diffusion of institutions<sup>51</sup>, and development leads to convergence (i.e. all countries are tending to adopt the institutions of the same kind) in at least some aspects of contract-enforcement mechanisms.

Once it is admitted that systems of contract enforcement vary in their efficiency, it becomes necessary to explain the determinants of efficiency in the hundreds of systems observed throughout the world. The recent economic literature tends to regard informal mechanisms as being more efficient than the legal system, for example, reputation provides a “free lunch” of enforcement without costs. Those whom Greif calls “economic sociologists” tend to think that exchange is generally non-anonymous and governed by trust, rather than by the legal system. In this view, these institutions of informal contract enforcement (trust) depend on exogenously determined social structures (networks). On the basis of these ideas, Greif then goes on to develop his theory (outlined above) focusing on the difference between individualist and collectivist systems.

Formal legal systems are thus not necessarily least-cost options for enforcing contracts and rights.<sup>52</sup> Formal systems may enforce bad laws which reduce economic efficiency. This may explain the negative correlation between the number of lawyers and the rate of economic growth in various countries, which was noted by Murphy, Shleifer and Vishny (1991). However, as Posner notes, this correlation is misleading because much of the output of lawyers consists of non-market goods. It must also be borne in mind that there are many informal substitutes for the legal protection and enforcement of property and contract rights. Posner’s list includes arbitration, reputation, merger, bilateral monopoly, strong-arm tactics and altruism. Property rights and contract enforcement are methods of coordinating and optimizing economic activities which existed long before states and formal legal institutions.

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<sup>50</sup> Greif (1997) mentions that the extent to which mechanisms such as better business bureaus, brand names, etc. coexist and develop alongside a legal system in the United States suggest that they enhance efficiency (relative to a system in which contracts can be enforced only by legal process).

<sup>51</sup> As pointed out by Lin and Nugent (1995, p.2319), the process of “induced institutional innovation” could function similarly to that described by Hayami and Ruttan (1985) for technological innovations.

<sup>52</sup> This refers mainly to the legal system governing the private economy, i.e. private contracts and property rights. Ostrom (1990) and Eggertson (1990, p.85) review the extensive literature on common property rights. Note that common property differs from public property.

A lot of empirical literature based on cross-country data establishes a statistical link between economic growth, as an independent variable, and various measures of the “efficiency” of the legal system (Knack and Keefer 1995; Mauro 1995; Brunetti, Kisunko and Weder 1997; Barro 1997; Chong and Zanforlin 1998; La Porta et al. 1998). These studies do not rule out complementary explanations of economic growth such as increases in investment or the effects of other institutional reforms such as an independent central bank. Methodological issues involved in cross-country regressions are discussed in sections 5.1 and 5.2. As it applies to the link between law and economics, this empirical literature suffers from several problems discussed by Messick (1999) in the context of judicial reform.<sup>53</sup> First, the proxies that are used are questionable. Reference is made in some cases to a vaguely defined “rule of law” (as discussed below), in other cases to legal traditions and legal families, and in yet other cases to an independent and predictable judiciary, necessary for predictable business transactions. Second, attempts to regress GDP per capita on some proxy of the efficiency of the legal system may fail to consider the endogeneity of the independent variables. Cross-country regressions fail to determine the direction of causality. The level of development and efficiency of a legal system may result from pre-existing attitudes and beliefs in the society at large, from trust or from “social capital” (Putnam 1993, Knack and Keefer 1997). It may also be the case that higher levels of development permit the state to spend more on law enforcement and the judicial system (Posner 1998). Or, as Pistor (1995) observed in a review of judicial and economic reform in the transition economies, the same factors that contribute to economic reform and development may also drive improvements in the judiciary.

Pistor and Wellons (1998) point out that the complex relationship between legal change and economic development changes over time. Taking the example of changes in legal institutions in Asian countries over the period 1960-95, they mention that legal reform was characterized at times by the “transplanting” of parts of Western law (competition law, environmental and consumer protection, intellectual property rights, securities and exchange regulations, etc). This was done in response to specific crises (environmental disasters, misuse of monopoly power, etc.), generally under political and/or financial pressure from foreigners. The economic “take-off” of the tiger countries went hand-in-hand with a strengthened role of the state, and legal change preceded the economic outcomes. During the 1980s, policy changes prompted economic change which, in turn, gave rise to the demand for new legislation, and the repealing of numerous laws shifted control rights from the state to the market. Pistor and Wellons (1998) describe the process of legal change along two axes of a matrix: the allocative dimension of the legal system (i.e. the legal rules that stipulate whether the state or the market determines the allocation of economic resources) intersects with its procedural dimension (i.e. whether procedures are rule-based or discretionary, which refers to legal and administrative institutions used to create and enforce laws), giving rise to four different modes of development.<sup>54</sup>

53 An additional problem is that the literature generally ignores the relationship between law and the concept of authority (mentioned in section 2.3. above), which is very different in the west than in the east.

54 Max Weber was the first person to look systematically and empirically at the relationships among the rule of law, a well-functioning judiciary and economic development, and proposed a comparative analysis of the role of law in China and the west (Messick 1999).

#### 4.4. What does the Rule of Law mean?

The “rule of law” seems to be an institutional innovation of 17<sup>th</sup> century England. In that particular historical context, it meant two things: that political rights had been granted to the wealthy to protect them against arbitrary violation of their economic rights by the King, and that the courts ruling on those rights had been made politically independent in order to limit potential abuses by Parliament (North and Weingast 1989). The law was then used against the vast majority of the people as a means of firmly establishing the private property rights of landowners and of eliminating the customary land rights invoked by the poor peasantry to justify their gathering of food on common land. The law, lawyers and judges were then the enemies of freedom and equality (Hill 1996).

Today, the term ‘rule of law’ has many connotations, most of them linked to the modern concept of democracy discussed in section 3.3.<sup>55</sup> One of these connotations is the protection of the individual against arbitrariness on the part of the government, i.e. the “negative rights” mentioned above. Another is that of checks and balances, for example the judicial review of the actions of the legislative and executive branches and of the administrative agencies of the executive, as elaborated by Montesquieu, Madison and the American constitutionalists and the German theorists of the *Rechtsstaat*.

The rule of law has established itself in Europe and North America after a long process of institutional change, along with other major elements: egalitarian values; civil and political liberties; political competition through elections and multipartism; representative democracy and the accountability of officials. Each of these elements is the result of separate (but covariant) historical developments. They co-exist in several countries, though at various levels of intensity, and are absent in others.

Another meaning of the term ‘rule of law’ is that people should be able to use the legal system to structure their economic activities and resolve disputes. This presupposes that the legal system imposed by the state is accepted by a majority of the populace. If the people distrust lawmakers, judges, public officials and the police because they lack credibility or are corrupt or inefficient, the people will turn to alternative forms of law enforcement such as local village elders, feudal lords or organized crime.

In contexts where no rule of law exists, the economic problem is to find least-cost methods of implementing legal reforms. In the context of Russia, Hay, Shleifer and Vishny (1996) point out that it is more costly and time-consuming to create efficient legal institutions than to enact efficient rules which can be administered by existing inefficient institutions.

When local or central state authorities fail to provide an acceptable set of legal rules and to enforce laws, as is presently the case in Russia, what is the cost of the absence of the rule of law and what can be done about it? There are essentially two avenues, which are not mutually exclusive. The first avenue is to improve the structure of incentives so that economic agents (civil servants, judges, etc.) act according to accepted legal rules. Posner cites examples of the

<sup>55</sup> Languages betray collective attitudes toward the state, and similar phrases have different connotations depending on the culture. The English “rule of law” is often translated as “*Rechtsstaat*” (more appropriately as ‘*Rechtsstaatlichkeit*’, whereas ‘*Rechtsstaat*’ would be more properly rendered as ‘a state in which the rule of law prevails’) in German or “*Etat de droit*” in French.

cost of judicial reform, including incentives for judges to behave with integrity (see also Becker and Stigler 1974). Bardhan (1997b) provides examples of corruption-reducing incentive systems. The second avenue is to invest in the “machinery” of the judicial system, especially when the country in question either has no tradition of the rule of law or the tradition has been forgotten, as is the case in, for example, the transition countries.

The fundamental trade-off is between making a rather modest investment in better rules and making a big investment in the judiciary. Making the point that growth can be stifled by excessive investment in public-sector projects, including legal reforms, Posner (1998) suggests emphasizing rules over institutional reform, but points out that this approach is more susceptible to failure in securing people against the threat of government confiscation, i.e. in the relations between the state and the individual, than in (contractual) relations between individuals.

#### 4.5. Legal Families

Posner conceptualizes Anglo-Saxon judicial systems as efficiency-maximizing methods of allocating resources which step in when the cost of market determination would exceed that of a legal determination (Posner 1973). In other words, the criteria applied by common law courts and by the market are the same, but the processes may differ. The controversial concept of “efficient law” used by Posner distinguishes between substantive and procedural efficiency. A rule is substantively efficient if it establishes a precept that internalizes externality or otherwise promotes the efficient allocation of resources. A rule is procedurally efficient if it reduces transaction costs, i.e. if it is designed to reduce the cost or increase the accuracy of using the legal system.

Derivation from a particular legal tradition (Anglo-Saxon common law, Roman-Germanic civil law, socialist law, etc.) is often taken to imply differences in efficiency. The superiority of the common law system vis-a-vis civil law or socialist legal systems is discussed in several empirical studies (e.g. Chong and Zanforlin 1998; La Porta et al. 1996; La Porta et al. 1998). The latter, for instance, conclude that “countries that use French or socialist laws exhibit inferior government performance”, while the former state that “countries that have a common law heritage tend to show a positive relationship with institutional efficiency.” This may very well be the case empirically, but these studies make little attempt to provide theoretical support for the purported evidence.<sup>56</sup> Why would judicial systems derived from the common law tradition be, on average, more efficient than those derived from the civil law tradition? Dewatripont and Tirole (1999) provide an explanation linked to the use of advocates. The judicial process in Anglo-Saxon countries is referred to as an “adversarial” system; it relies heavily on lawyers, advocates of their client’s cause. There is a partisan (and often aggressive) process for uncovering the truth, which includes safeguards such as the privileged lawyer-client relationship to ensure the transfer of information and the judge plays a relatively passive role. By contrast, the

<sup>56</sup> One problem with such cross-sectional regressions is that they do not allow countries to belong to several legal families, even though — as mentioned above — such traditions frequently exert a substantial influence in former colonies and countries that have long been under foreign domination such as Japan. It is often the case that part of a legal system is derived from one legal heritage, while another part is derived from a different heritage. Most disconcerting for these large-scale cross-sectional exercises is the fact, pointed out by Pistor and Wellons (1998, p.4), that “for economic law the distinction between common (English) law and civil (continental European) law has had little bearing on the development of the [Asian] economies’ legal systems.”



judicial process in civil law systems is called “inquisitorial”. In this case, the lawyers play a relatively passive role; the process has the appearance of greater impartiality and the judge(s) have substantial latitude to direct the debates, select expert witnesses, etc. Dewatripont and Tirole offer one explanation for the possibly superior performance of the Anglo-Saxon system on the basis of informational and incentive arguments. They argue that the adversarial system is more efficient because the rewards for advocates are closely linked to their performance, whereas non-partisan incentives are impaired by the agents’ pursuing several conflicting goals at once, and costs are lower because information cannot be manipulated as easily.

Every legal system incorporates a trade-off between legal rules and their enforcement. Some rules are simple, and their application is relatively mechanical. By contrast, legal standards such as negligence, bad faith, unreasonable restraint of trade, unconscionability, etc., require interpretation by professional judges. Rules are therefore cheaper to apply than are standards. Moreover, rules are less uncertain, facilitate the monitoring of judges and thus reduce the likelihood of bribery and the influence of politics in the judicial process. Rules are often more accurate, though this may be illusory since “it is a property of governance by rules that they never quite fit the complex reality that they govern” (Posner 1998).

Empirical work on corporate governance, shareholder rights and creditor rights reported by La Porta et al. (1996) provides evidence on the trade-off between legal rules and their enforcement. Statistical results on per capita income levels, rules and their enforcement from cross-country data indicate that relatively wealthy countries have law enforcement of higher quality than relatively poor countries. However, it is not the case that weak legal rules (in terms of protecting shareholders and creditors) are associated with poor countries.

## 5 Empirical Issues in Assessing the Links between Governance and Development

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This section surveys empirical studies on governance. It begins with a discussion of methodological issues raised by these studies, including finding adequate data to measure the various dimensions of governance; specifying the model; and estimating robust statistical relationships between variables. The discussion is followed by a review of some of the literature dealing with the determinants and effects of governance in a cross-country context. The section then concludes with an example of a governance issue within a single-country context, a study of market-preserving federalism in Russia.

### 5.1. Methodological Problems

#### *Data Problems*

Researchers encounter three main problems with data. First, in order to measure efficiency, data on both inputs and outcomes are required. Second, public and private activities are not always comparable. Third, since there are no direct measures of governance, it is necessary to use proxies.

Available data on government activity are, on the one hand, public resources spent on inputs and, on the other hand, outcome indicators such as illiteracy rates, morbidity, infant mortality, school achievements, infrastructure characteristics, etc. Since governments do not spend money equally effectively, these numbers per se tell us nothing about government efficiency.

Since the incentives to improve the quality and reduce the cost of public goods are stronger for private providers than for public ones, it is necessary to have data on both the quality and the quantity of output in order to compare public and private activities. Quality characteristics can be handled in a qualitative dependent-variable framework, but some attributes such as effort may not be directly observable. While it is possible to measure physical productivity (output per unit of physical input) in relation to private goods, measuring productivity in relation to many public goods and to services provided by the public sector remains a challenge (World Bank 1997a, p.33). We might find comparative data on the wages and labor needed to produce private and public goods, but what number of employees is appropriate for the production and provision of collective services, such as defense, maintenance of law and order; legislation and regulation, etc.? Since this problem is hard to resolve, public accounts are based, in value terms, on the assumption that “the value of the final consumption of general government is taken to be equal to the value of the expenditures they incur on collective services.” (UN 1993, para 9.91, p.215).

Third, because the true explanatory variables are unobservable, virtually all governance variables are proxies. This means that the variables used are not really what we want to measure. Proxies may be either quantitative (e.g. the number of changes in government as a gauge of ‘political instability’) or qualitative variables (e.g. the subjective ranking of contract enforcement as

a gauge of ‘institutional efficiency’). For example, Putnam (1993) constructs an index of institutional performance consisting of twelve proxies in his study of Italy.<sup>57</sup> In their cross-country analysis, Knack and Keefer (1995) use indicators of government effectiveness produced by two private rating agencies, International Country Risk Guide (ICRG) and Business Environmental Risk Intelligence (BERI), while Mauro (1995) uses similar indicators produced by Business International (BI) to analyze public efficiency.<sup>58</sup> These indicators have subjective values ranked on an ordinal scale. Apart from the usual econometric difficulties (For example, a proxy, by definition, contains measurement errors and thus results in a biased estimate), some of these studies also show a certain sloppiness in their selection of variables. The problem is not that they employ proxies; it is rather that some explanatory variables used in these studies are poor proxies for describing the characteristics of legal or political systems.

### *Model Specification*

Specifying an adequate model for testing is an additional challenge. When unsuspecting researchers are confronted with available theories of governance and available data, two things happen to them. First, they are ‘fooled’ by the data. Since they are looking at proxy indicators, the researchers think they are measuring one thing when in fact they are measuring another. For example, using the ICRG ‘rule of law’ indicator, they could think they are estimating the relationship between GDP growth and the security of property rights, when they might in fact be measuring the relationship between GDP growth and submission to authority.<sup>59</sup> Second, researchers may think that they are measuring a direct, first-order effect between two variables when the effect is in reality second-order or third-order.

In regard to the first point — being fooled by the data, it has to be mentioned that there is a high correlation between the various governance indicators in available data sets (Freedom House; ICRG; BERI, etc.), even though these dimensions are conceptually and empirically distinct (Knack and Keefer 1995, Isham et al. 1997). Given this correlation, the only assertions that can be made with confidence are that, in a particular time period, some governments are efficient but not democratic; some are democratic but have a weak rule of law; some are democratic but corrupt; etc. It may be presumptuous to go a step further and claim to infer from an empirical observation of countries the “true” relationship between growth and governance.

Regarding the second point — the nature of direct and indirect effects between variables, many researchers have observed that the causal relationships between institutional factors and economic outcomes is very complex. Some effects are contemporaneous; others have a particular lag structure. Some institutions, such as the caste system in India, go so far back in time that it is pointless to look for data. Isham, Kaufmann and Pritchett (1997) is a concrete example of the difficulties involved. These authors examine empirically the links between civil liberties and

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57 The indicators are reform legislation, day-care centers, housing and urban development, statistical and information services, legislative innovation, cabinet stability, family clinics, bureaucratic responsiveness, industrial policy instruments, budget promptness, local health unit spending, and agricultural spending capacity (Putnam 1993, chapter 3).

58 The ICRG and BERI institutional data sets are combined with large, cross-country data sets of economic variables, including Summers and Heston (1994), Barro (1991), World Bank (1997) and Deininger and Squire (1996). These datasets are generally available on the Internet, free of charge. A fee is charged for the complete ICRG, BERI and BI datasets, but some subsets are available on the Internet.

the performance of public-investment projects. The issue they address is the following: it has been documented that the economic rate of return (ERR) of public projects is affected by bad policies (or policy distortions), but is it also affected by “voice”? Can one ascertain empirically that a more democratic environment leads to more participation of citizens in the affairs of the state, greater accountability of public officials, and therefore to less waste and corruption and more efficient public projects, in short, to better government? Consider that this would involve using cross-country data to test empirically at least four different types of propositions (each involving a particular effect):

- Democratic political systems are more conducive to participation.
- Decision-making processes such as voting tend to promote the adoption of better policies.
- These better policies lead to better outcomes.
- A climate of freedom, in and of itself, leads to more efficient and/or equitable public policies.

The Isham et al. paper establishes empirically that civil liberties, i.e. freedom of the press and media, and freedom to organize and dissent, facilitate voice and that more voice leads to better economic outcomes (in this case, projects with high rates of return). Using a data set on World Bank projects and many other variables, they find that “the impact of civil liberties is as empirically large as the more celebrated impact of economic distortions on project returns.” It would not be easy to make a theoretical model of the many first- and second-order effects that are involved here, even if the econometrics and the empirical results are convincing. Cross-country models are very sensitive to specification. When one believes to have identified a significant correlation, one must first control for other relevant variables before placing much confidence in the correlation. However, finding a robust partial correlation certainly does not imply that the variable of interest causes growth. Because of specification bias, Levine and Renelt (1992) rejected many of the explanations put forward in previous studies. They conclude that “national policies appear to be a complex package and future researchers may wish to focus on macroeconomic policy regimes and interaction among policies as opposed to the independent influence of any particular policy”. Model specification problems are even more acute when institutional variables are brought into the picture, in addition to economic variables (which were the only ones reviewed by Levine and Renelt).

### *Statistical Estimation*

The statistical framework used for observations derived from a non-experimental setting (including the kind of cross-country observations described above) is a regression model in which the outcome variable  $y$  is related to a set of explanatory variables  $x$ . At least one of the  $x$ -variables is the variable of interest, while others are control variables, which are included so as to allow for the differences in outcomes not caused by the variable of interest and which allow the effect of the variable of interest to be isolated. These variables play the same role as the control

59 The ICRG's rule of law indicator measures citizens' willingness to accept established institutions in legislative, executive and judicative roles (see Knack and Keefer 1995, p.225).

group in an experiment. The error term in the regression captures omitted controls, as well as the measurement error in the outcome  $y$ , and is assumed to satisfy the condition that the expectation of  $y$  conditional on  $x$  is  $\beta'x$ . The effects of the variable of interest and the controls can be recovered by estimating  $\beta$  (Deaton 1997).<sup>60</sup> There may be several situations of correlation between error term and explanatory variables.

*Omitted Variables.* First, if a relevant variable is omitted, perhaps because it is unobservable or because data are unavailable, and if that variable is correlated with any of the included  $x$ 's, the error will not be orthogonal to the  $x$ 's and the conditional expectation of  $y$  will not be  $\beta'x$ . The regression function no longer coincides with the structure that we are trying to recover. For instance, in the example above of the link between civil liberties and ERR, it is possible that some omitted variable is associated with both civil liberties and ERR, so that the results could be a statistical artifact. The practical solution in such cases is to experiment with variables that could be associated with democracy such as education, human capital, ethnic fractionalization, etc. as Levine and Renelt (1992), Barro (1997), Sala-i-Martin (1997), Easterly and Levine (1997) and many others do.

*Endogeneity.* A second possible situation of correlation between the error term and explanatory variables is simultaneity (or feedback through time). If some of the explanatory variables are determined by factors that include  $y$ , then the error term will be correlated with one or more of the  $x$ 's and OLS estimates will be biased and inconsistent. If institutions are endogenous to the process of economic growth, then a single equation approach is not possible. (The reason why the single equation approach is being used in the empirical growth literature is because, for one reason or another, the authors consider that these institutional variables are pre-determined). An example of endogeneity between institutional and economic variables is the study on economic growth and political instability by Alesina et al. (1996), who consider joint endogeneity of these variables. A single equation approach would have a simultaneity problem: since the propensity of government change and economic performance are endogenous, estimating the effects of instability on growth without controlling for the effects of growth on instability would yield a biased estimate. They therefore use a structural system of two equations, one for growth and one for political instability, with one exogenous variable in the growth equation that is not in the equation for government change, and vice versa.

Endogeneity of the explanatory variables is a common problem in models testing institutional factors that influence growth such as political systems, quality of legal systems, etc. For instance, La Porta et al. (1998) point out that the scale of economic activity (GDP per capita level) is endogenous to the quality of government. Richer countries have better government. As the scale of economic activity expands, better institutions become affordable and hence one would expect economic performance to improve. Of course, better government improves economic performance, so the scale of activity is endogenous. When endogeneity is controlled for, the statistical significance of some coefficients "explaining" growth decreases sharply or vanishes.

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<sup>60</sup> Using panel data (i.e. using repeated monthly or yearly observations for each individual country) makes it possible to use the same country as its own control. See the discussion in Deaton (p.107).

Granger causality tests have been applied to institutions, for example by Chong and Calderon (1997) and by Campos and Nugent (1998). Granger causality is, after all, a kind of statistical feedback. Even after checks have been made to control for appropriate variables, the existence of a statistically significant relationship between governance and economic outcomes does not in any sense imply that a particular institution “causes” an economic outcome. Testing for Granger causality simply leads to the conclusion that, in a specific time-series context, “the conditional distribution, lagged values of  $y_t$  add no information to explanations of movements of  $x_t$  beyond that provided by lagged values of  $x_t$  itself” (Greene 1997, p.714). Chong and Calderon (1997) simply entertain the confusion when they state that “the results [of their analysis] seem to confirm previous cross-section studies that somehow provide evidence on the causality from institutional quality to economic growth. Although institutional efficiency Granger-causes economic growth, it also seems to be the case that economic growth Granger-causes institutional efficiency.”<sup>61</sup>

In evaluations of the effectiveness of public policies and programs, it is usually impossible to maintain that the explanatory variables are uncorrelated with the regression residuals, i.e. with unobserved characteristics (Deaton 1997 p.97). For example, health outcomes may appear, from the regression results, to be better in areas where the government has put clinics, but it may simply be because of the process whereby the sites are chosen, of which the analysis takes no account.

This kind of selection bias is a frequently encountered problem. For instance, if one examines the link between political regime and growth, it would be erroneous to conclude that “accelerated growth requires an authoritarian regime” from a sample showing that, say, authoritarian regimes grow at a rate of 5% per year and democracies at a rate of 2% per year over a period of twenty years (Przeworski and Limongi 1993). Observations are not generated randomly because of selection bias: the probability of survival of a political regime conditional on growth is not the same for all regimes (i.e. an authoritarian regime is less likely than a democracy to survive adverse economic conditions). Estimates are biased and inconsistent because observations are not generated randomly. In these cases, limited dependent-variable models should be used (Kennedy 1998, p.251).

One final estimation issue that will be mentioned only briefly is that, when long time series are used, there is a strong correlation between government variables such as public expenditure (size of government) and “trend” variables that also grow over long periods.<sup>62</sup>

61 The rooster crowing Granger-causes the sun to rise in the morning and Christmas card sales Granger-cause Christmas (Kennedy 1998).

62 This was already mentioned by Tullock in his critique of the Metzler and Richard model (Mueller 1989 pp.341-2).

Summarizing this section on econometric estimation, it may be said that many measurement errors arise when a proxy variable is treated as the true variable. The OLS estimator will underestimate the estimated coefficient, whereby the degree of underestimation will depend on the variance of the true variable. The solution, in most cases, is to use instrumental variable techniques. The OLS method will produce biased estimates if the explanatory variable is correlated with the error term in the regression equation. If the problem is omitted variables, the model has to be re-examined. If the problem is a simultaneous equation bias or serially correlated residuals and lagged dependent variables, the use of instrumental variable technique usually solves the problem.<sup>63</sup>

### 5.2. Cross-country Regressions

Over the last ten years, there has been an explosion of cross-country studies on the institutional determinants of growth. The literature on growth has focused on property rights, contract enforcement, the rule of law, etc. because of the close links existing between investment (and investors' behavior) and these legal institutions. Empirical research has been facilitated by the existence of large databases (available on the Internet) with hundreds of economic and social variables on a very large number of countries over long time periods, and by improvements in econometric software. This empirical research has coincided with the resurgence of growth theory following the seminal paper by Barro (1991).

The previous sub-section discussed some econometric issues that arise in cross-country regressions of GDP growth and institutional variables that are (cor)related with governance. It also discussed the links between theoretical models and econometric models and made the point that the hypotheses supporting the evidence were in some cases a-theoretical, i.e. offering plenty of facts, but not much theory.

This sub-section briefly discusses the economic intuition behind the results of some important cross-country studies. It makes no claim to survey, even cursorily, the cross-country evidence on growth and governance.<sup>64</sup> The studies reviewed here have in common that they include in the regressions not only economic variables, but also a wide range of political, historical, cultural and religious variables. The studies may be divided into two groups in that, in some of them, the dependent variable is an economic outcome, while in others, the dependent variable is the quality of government.

*Determinants of Governance Structures.* In a limited number of studies, the dependent variable is some measure of the "quality of government" and the question asked is: what accounts for the variation in governance observed across countries? For instance, in one of the most comprehensive exercises, La Porta et al. (1998) use as dependent variables various indicators of government intervention, public sector efficiency, public good provision, size of government and political freedom, and regress them against such "fundamentals" as ethnic fragmenta-

63 For instance, Barro (1997b, p.16) argues in favor of 3SLS when using panel data because the residuals from the growth rate equations are essentially uncorrelated across periods which are five to ten years apart.

64 The papers reviewed are Alesina, Özler, Roubini and Swagel (1996), Barro (1991, 1997b), Chong and Calderon (1997, 1998), Easterly and Levine (1997), Knack and Keefer (1995, 1997), La Porta, Lopez de Silanes, Shleifer and Vishny (1996, 1998), Levine and Renelt (1992) and Sala-i-Martin (1997).

tion and legal tradition. They conclude that “countries that are poor, close to the equator, ethnolinguistically heterogeneous, use French or socialist laws, or have high proportions of Catholics or Muslims exhibit inferior government performance, [and that] larger governments tend to be the better performing ones.” Knack and Keefer (1997) use trust and civic cooperation as dependent variables and adopt a similar approach to test the hypothesis that “social capital matters”.

*Effects of Governance Structures.* In the majority of studies, the dependent variable is GDP per capita, which is regressed against a host of economic and institutional variables.<sup>65</sup> In this case, the statistical evidence “consists of regressions in which investment is controlled for, so that political effects measure efficiency but not the capacity to mobilize savings.” (Przeworski and Limongi 1993). The international indicators of governance most frequently used are:

- Political Rights and Civil Liberties: Subjective ranking of countries from a survey published annually by Freedom House (previously Gastil). The survey does not rate governments per se, but the rights and degree of freedom individuals have in each country. Political rights enable people to participate freely in the political process. Civil liberties are the freedoms to develop views, institutions and personal autonomy apart from the state (Freedom House 1998, p.593).

- Government Quality: Subjective indicators of risks faced by (mainly foreign) investors, published by the private-service rating agencies mentioned earlier (ICRG; BERI and BI). For example, the ICRG data set contains five indicators: law and order tradition, risk of expropriation, repudiation of contracts by governments, corruption in government and quality of bureaucracy. The BERI data set consists of four main indicators: contract enforcement, nationalization potential, bureaucratic delays and infrastructure quality.<sup>66</sup>

An example is presented to show the effects of governance on economic performance in a cross-country context. Per capita income ( $Y_{it}$ ) is regressed on two institutional indices controlling for economic variables, using a sample of 59 countries over the period 1970-90. The model follows Barro (1991) and assumes that GDP growth in country  $i$  at time  $t$  is a function of the initial level of GDP; of the human capital stock (initial level of educational attainment); of institutional variables and of several economic variables: investment, openness to trade, inflation, monetization of the economy and terms of trade shocks (average change and standard deviation in the external terms of trade).<sup>67</sup> Here, the two institutional indexes mentioned above are used. The first index includes the two Freedom House variables: GOVERNANCE1 = POLRIGHT + CIVLIB and the second includes four ICRG variables: GOVERNANCE2 = RULELAW + CORRUPT + GVTREPUD + EXPROPR. This study uses a panel-data approach in that it pools the cross-section of variables at three points in time (1970, 1980, 1990) to eliminate serial cor-

65 In Chong and Calderon (1998), the dependent variable is income distribution. See footnote in section 3.1.

66 Political instability indices are also frequently encountered in the literature. They include frequency of anti-government demonstrations, political assassinations, cabinet changes, constitutional changes, coups, government changes, purges, revolutions and riots. See for example Barro (1991) and Alesina, Ozler, Roubini and Swagel (1996). The main sources are Banks (1994) and Jodice and Taylor (1983).

67 The dependent variable is GDP (average annual growth per capita in constant local currency units, measured as the log difference in per capita GDP between 1970 and 1990, divided by the elapsed time period), and the explanatory variables are: GDPINIT (initial per capita GDP in 1970 in constant \$), INVEST (gross domestic investment as a ratio to GDP), INFLATION (annual average CPI increase over 1970-90, using a Laspeyres index), EDUC (average schooling in years of the total population aged 15 and above), EXIM (ratio of the sum of exports and imports over GDP), M2/GDP (ratio of money and quasi-money over GDP), TOTAVERAGE (annual percent change in the terms of trade, i.e. the ratio of the export price index to the import price index), TOTSTANDDEV (standard deviation of the terms of trade) and the two GOVERNANCE indices, which are simply the sum of institutional variables (2 for Gastil and 4 for ICRG) rescaled to a 10-point scale.



relation, but employs ordinary least squares (OLS) assuming, as Barro (1991) does, that the problem of omitted variables is not serious enough to warrant a procedure such as fixed effects (Greene 1997).<sup>68</sup>

We expect to find a positive relationship between governance and economic growth, i.e. that higher values of the governance index would be associated with higher growth rates. However, it is first necessary to control for the influence of other variables affecting growth.

To this end, the regression is partitioned (Greene 1997, p.245-250). If  $\alpha_0$  is the coefficient of the constant term,  $X_1 = \text{GOVERNANCE}$  and  $X_2 = \text{CONTROL}$  are the columns of the partitioned matrix of observations on the governance and control variables, respectively, then

$$Y = \alpha X + \varepsilon = \alpha_0 + \alpha_1 X_1 + \alpha_2 X_2 + \varepsilon \quad \text{where } \varepsilon \text{ is residual.}^{69}$$

In order to obtain the true relationship between per capita income (Y) and the institutional index, per capita income is first regressed on the CONTROL variables and the portion of the growth rate that is not associated with these control variables (i.e. the residuals) is calculated. Then, in a second regression, we regress the GOVERNANCE variables on these same control variables and again calculate the portion of the institutional index that is not associated with these control variables (i.e. the residuals). This is followed by an estimation of the linear relationship between these two sets of residuals.<sup>70</sup> The intuition behind this procedure is to determine how much of the variation in growth rates across countries is attributable to economic factors. Then it is necessary to determine how much of the variation in governance across countries is attributable to these same economic factors (e.g. corruption may increase with a worsening in the terms of trade). Once the fractions of growth and of governance which are not associated with these economic factors have been isolated, we can be sure that we are measuring the “true” relationship between governance and economic performance. The results are shown in Figures 1 and 2. The graphs show the contribution of these governance factors to economic growth, in terms of deviations from the average. So the fact that, say, Malaysia ranks higher than France in terms of government quality should be interpreted to mean that improvements in the quality of government explains more of GDP growth, compared to the average, in Malaysia than in France during that period.

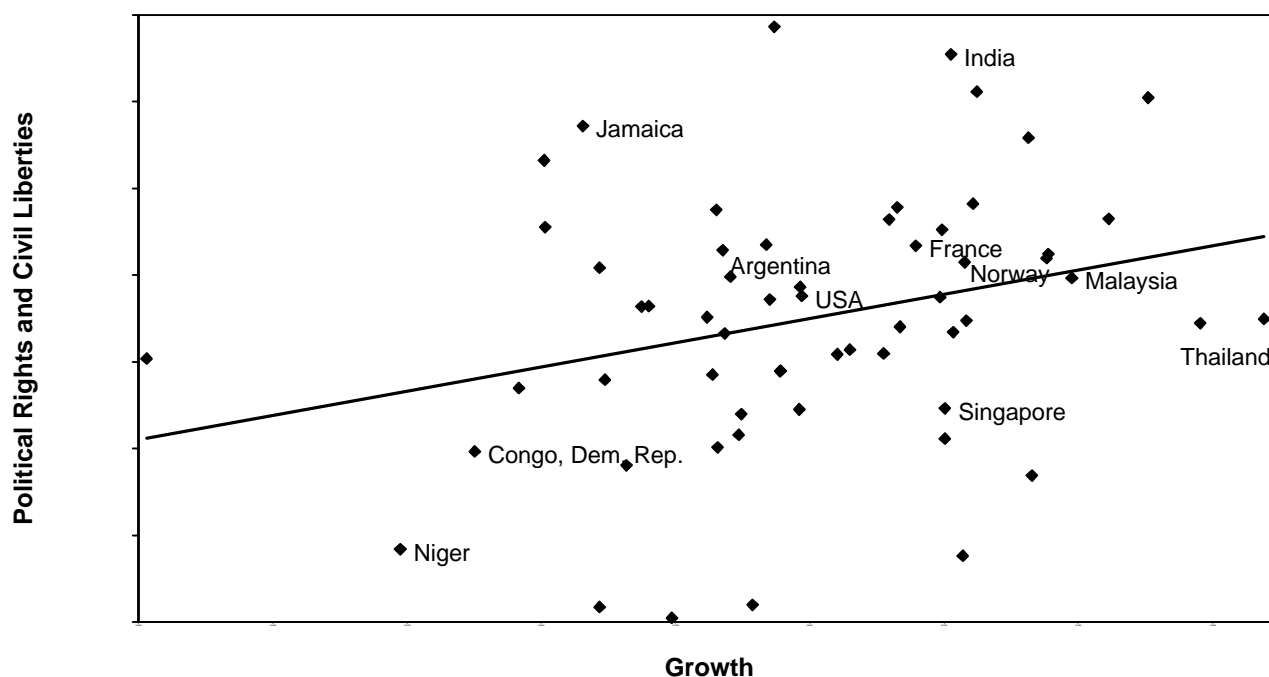
These cross-country results indicate a positive relationship between growth and both definitions of governance in the sense that higher scores on the governance index are associated with higher per capita GDP growth rates, but also indicate that the relationship is weak - at least when one controls for the ‘usual suspects’ pointed out by the theory of growth (initial level of GDP; investment in physical and human capital, trade regime, terms of trade shocks, and fiscal and monetary policy). The conclusion, as others have already pointed out (Przeworski and Limongi 1993; Castelar Pinheiro 1996), could be that cross-country work on governance is fraught with such difficulties that investing in such activities may be of little value.

<sup>68</sup> Since institutions are very stable over time, there would be hardly any variation, and the institutional variables would drop out of a fixed-effects estimation (Knack and Keefer 1995, p.215).

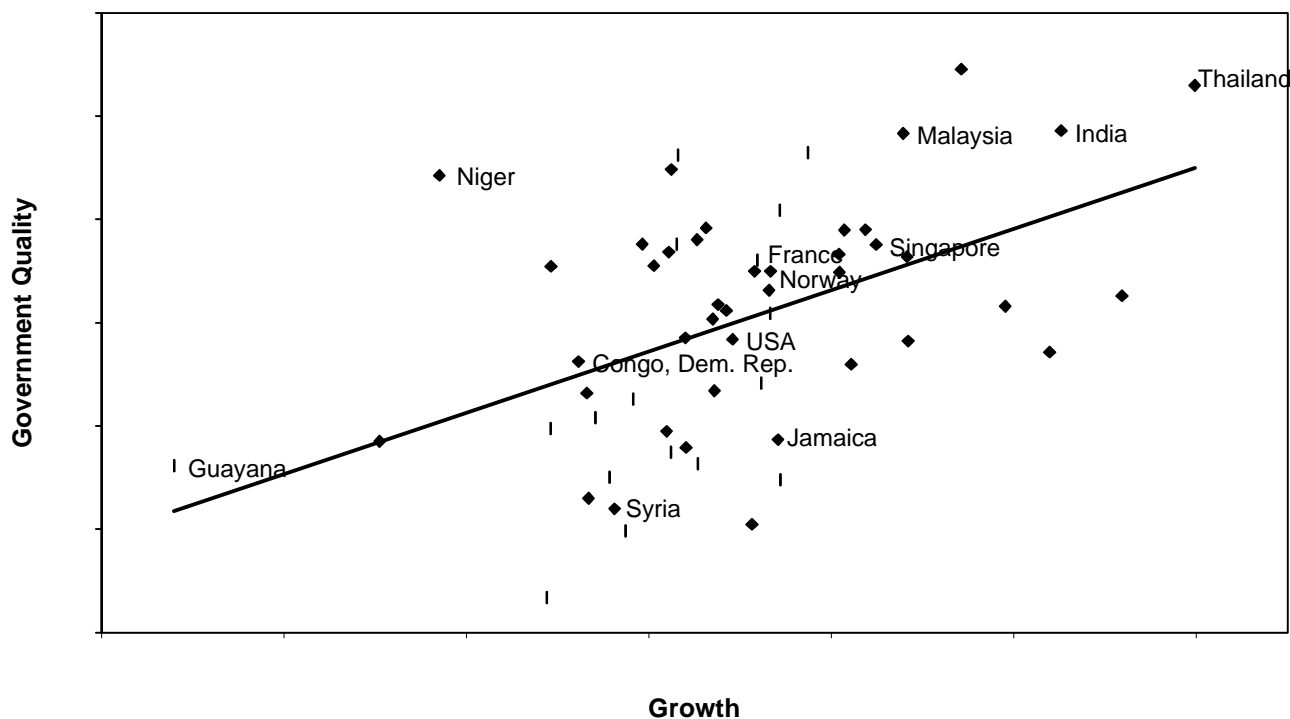
<sup>69</sup> Because there is a constant term in the equation, the data have to be defined in terms of deviations from the means.

<sup>70</sup> For a similar exercise, see Burki and Perry (1998).

Freedom and Growth 1970 - 1990



Government Quality and Growth 1980 - 1990



### **5.3. Empirical Research in a Single-Country Context**

Cross-country studies yield limited insights, possibly because, in a large sample of countries, it is difficult to focus on a small number of policy variables (Alesina et al. 1996). One needs to control for too many variables in order to be certain that one is really measuring the effects which a particular institution or incentive scheme is having on the economy.

In a single-country context, it is possible to focus on a small number of policy variables. Even though legislation or policies have nation-wide applicability, there are wide regional and local variations in administrative and organizational capabilities, so that corresponding variations in the effectiveness of utilization of public resources, in the enforcement of legislation, etc. are observable. Regional variability and variability across groups of individuals who have different access to power, different influence and different income levels; who belong to different ethnic groups, etc., provide a basis for quantitative assessment.

One example of such research is the study on “market-preserving federalism” of Zhuravskaya (1998), which analyzes the incentives created by the fiscal system in Russia. The theory of market-preserving federalism was developed in the context of China by Qian and Weingast (1996, 1997) and Qian and Roland (1998). Zhuravskaya (1998) extends the theory to the Russian case. This discussion is taken from her paper.

The governments of China and Russia have comparable organizational structures and fiscal-federal relations in the sense that they have a similar distribution of expenditure responsibilities among levels of government and that different sources of revenues for local governments can be compared (own and shared revenues in Russia, and budgetary and extra-budgetary revenues in China). However, Chinese and Russian fiscal systems differ in one major respect: in their revenue-sharing scheme and in the incentives that they create.

In China, the lower level of government contracts for a long period with the upper level of government regarding the share of revenues to be remitted to the upper level for the next several years. The lower level of government keeps the remainder of the revenue collected (its within budget revenue). Extra-budgetary funds, which make up about 50% of local government revenues, are not subject to any sharing. The upper level of government credibly commits, to a degree, not to confiscate additional revenues from the lower levels because they are not given information about these revenues. Local governments thus become “residual claimants” and, therefore, have strong incentives to maximize local revenues.

In Russia, schemes for sharing revenues between tiers of government are renegotiated frequently. Treisman (1996) provides econometric evidence showing that federal grants are distributed purely according to political negotiation and do not follow economic objectives. He shows that negotiations between the central and the regional governments regarding sharing schemes have given regional governments incentives to encourage separatist movements and other forms of political revolt against the federal government.

Zhuravskaya (1998) focuses on the effects of fiscal negotiation between local governments and regional governments. The components of shared revenues and transfers are determined through annual negotiations between local and regional officials. Shared taxes and transfers are not determined on the basis of any fixed formula, and vary both over time and across

cities within a single region. Note that revenues from shared taxes and transfers are perfect substitutes for both regional and local governments, so that there is no conceptual difference between shared taxes and transfers. Zhuravskaya has collected her own survey data on Russian municipal budgets. She sent a questionnaire with detailed retrospective questions regarding expenditure and revenue in the period 1992 – 97 to 35 large cities in 29 different regions. The survey focuses on local public goods (spending on health and education) and on support for (or absence of regulations on) private businesses. She constructs various proxies for incentives faced by local governments. She formulates and tests four major empirical hypotheses based on a theoretical model showing how fiscal incentives influence local support for private business growth and the efficiency of public goods provision (health care and education). Her econometric results, which are carefully checked for robustness, indicate that, in Russia, revenue sharing between regional and local governments provides local governments with no incentive to their increase tax base or provide public goods. Any change in local governments' own revenue is entirely offset by changes in shared revenue. This leads to predatory governmental behavior towards new businesses. She thus shows empirically that these fiscal incentives are strong determinants of the formation of private business, of the composition of public spending and of the efficiency of public goods. This "Russian style" fiscal federalism is compared to the Chinese model of fiscal federalism, in which the fiscal incentive scheme is much stronger according to Qian, Weingast and Roland.

## 6 Concluding Remarks and International Development Policy Implications

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This concluding section formulates some remarks on the tasks of research in the field of governance and describes some of the implications of the issues discussed in this paper for international development policy.

### 6.1. A Possible Agenda for Applied Research

An agenda for applied research on developing and transition countries should combine three elements: take advantage of recent theoretical breakthroughs, select case studies that are rich in empirical potential and focus on questions that are socially relevant. Such an agenda should concentrate on the critical aspects of the effectiveness of government in the development process: political, economic and legal aspects. Combining the economics of incentives with the study of institutions, it should examine empirically the evolution over time of particular governance structures. Research should focus on measuring the benefits and costs of institutions and the outcomes of particular policies or public goods in terms of their efficiency and effects on the welfare of various population groups. The theoretical research agenda is to develop an incomplete-contract approach to public decision-making (Laffont and Tirole 1993; Tirole 1994). Recent papers in fiscal federalism, checks and balances and other areas are beginning to fill this vacuum.

Incentive economics remains a relatively theoretical field, although a few empirical models of adverse selection and moral hazard have been recently tested. Most of them have been in the area of regulation.<sup>71</sup> Concerning institutions, there is, on the one hand, a lot of cross-country evidence on their determinants and effects (some of it discussed in section 5.2) and, on the other hand, microeconomic studies on specific institutions such as sharecropping, traditional households, land policies and property rights, etc.<sup>72</sup> There are also several penetrating economic history monographies (such as North and Weingast 1989, Milgrom, North and Weingast 1990) that throw light on specific aspects of the development of institutions.

Also needed are more country-specific and context-specific studies<sup>73</sup> examining particular incentive schemes and control rights under various institutional settings, from the point of view of their impact on development. Such studies would use microeconomic survey data and investigate specific legal reforms (e.g. regulatory reforms and welfare rights), government policies (e.g. education and health policy) or the provision of roads, schools and other public infrastructure in particular regional or local settings. The use of panel data would be desirable since it

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<sup>71</sup> Both Laffont and Tirole (1993) and Salanié (1997) cite Wolak (1994), who studies the regulation of water utilities in California.

<sup>72</sup> For a survey, see Lin and Nugent (1995).

<sup>73</sup> For example, the context could be the historical transition process of former socialist countries and the problems of unemployment and poverty that they pose, or the situation of ethnic polarization, civil war, collapsing economy and rampant poverty faced by many African nations.

would make it possible to track institutional change over time. By focusing on regional and local variability, such studies could examine how an identical institution (e.g. the enforcement of the same legal rules) responds to different local political and social situations.

Research can make significant contributions in two important areas where several theoretical and empirical issues remain unresolved: institutional change, and the political economy of reform.

*Institutional Change.* Institutions are path-dependent and need not be efficient to persist. What does it take to eliminate inefficient institutions? What does it take to create efficient ones? Can political, legal and administrative systems change "from within" or is a foreign influence or a "shock" from outside necessary (such as migration, new technology, a change in the terms of trade or the imposition of conditions by an international lender)? Can such an "external" shock have counterproductive implications? Case studies could examine how societies shift from a situation of low equilibrium to a higher equilibrium (see section 2.2) and how institutions of credible commitment can be constructed.

*Political Economy of Reforms.* At the beginning of the 1990s, deteriorating macroeconomic situations in many developing countries led their governments to adopt more open external policies, creating winners and losers. In India, for instance, public-enterprise workers and bureaucrats benefiting from the 'license raj' (unclear laws and regulations leaving a lot of leeway for interpretation and giving these officials a *raison d'être*) have been the losers of the liberalization policy, while the new educated class and the growing private sector have been winners. The poor, in particular in rural areas, do not appear to have benefited much from the change, while the local elites have maintained their advantages. It is unlikely that inefficient institutional arrangements will collapse by themselves, though there is of course a great diversity of regional situations. How can a "critical mass" of people benefiting from the reforms support further profound reforms that are macroeconomically and fiscally responsible, significantly reduce poverty and generally have welfare-enhancing effects?

In more specific areas, the research program could consider three themes.

*Decentralized Authority and Intergovernmental Fiscal Issues.* The research program would consider trade-offs between the benefits of centralization (in terms of policy coordination) and costs (in terms of diminished accountability); externalities between central and local governments; and conflicts of interest when transfers are involved between rapidly growing regions and slow-growth regions in large federal countries. Comparative work would be useful, for example contrasting the systems of Russia and China, or different local governments in India from the cross-sectionally very uneven third layer of local governance (panchayats and urban municipalities) created by the 1993 constitutional reform.

*Governance Issues in the Provision of Local Public Goods.* The research program would examine existing incentive schemes for promoting democratic participation in the provision of local public goods; decision-making and financing for public goods such as health care, primary education and local infrastructure; mechanisms of accountability of the authorities; reduction of transaction costs in the public sector and of corrupt practices. The focus would be on the efficiency with which different local governments provide public goods and on the equity aspects of the local provision of health care and education to various income groups, both urban and rural.

Examining from these perspectives the diversity of local experience in India, China and Russia would be complementary to the fiscal decentralization research suggested above.

*Legal Systems and Economic Efficiency.* The research program could include several case studies investigating the effectiveness with which existing legal institutions support the market economy; the inadequacy of legal rules in the face of the changing market economy, the need for new rules (or the overhauling of existing legal codes) and the problems of possible misalignment of incentives posed by 'transplanting' foreign laws. Of course, it would be necessary to consider not only the rules themselves, but also their interpretation by judges, the operation of the judicial system and issues such as the independence of the judiciary, available alternatives for resolving conflicts and the speed of dispute resolution.

The growing body of evidence that exists in this field is concerned primarily with the regulation of businesses, utilities and infrastructure projects — understandably so, given the focus on development of the private sector. Welfare issues, their relationship with insurance and their legal implications have not been investigated sufficiently by this literature. A promising avenue of research would be to analyze, for selected countries, welfare legislation dealing with various forms of risks (health care, unemployment, old-age security, social assistance) which would be both affordable and efficient in an insurance (risk-sharing) sense. Another little-researched area is that of legal models that have been adopted by reforming economies and the problems that have arisen consequent to the "transplanting" of laws.

The research agenda outlined above is closely related to existing studies on the political economy of reform (see Bardhan 1998, Roland 1997, Rodrik 1996), to recent work on fiscal federalism (Qian and Weingast 1996, 1997; Qian and Roland 1998; Zhuravskaya 1998), on checks and balances (Persson, Roland and Tabellini 1997), on the delivery of local public goods (Bardhan and Mookherjee 1998) and on legal reform (Sachs and Pistor 1997).

## 6.2. International Development Policy Implications

In conclusion, some comments will be made on the relevance of governance research for the donor community and for international organizations providing loans and policy advice. There has been a shift in development thinking away from government-led strategy to a focus on the 'fundamentals', including the role of incentives and institutions. This shift is reflected in the comprehensive study of the World Bank assessing the impact of aid (World Bank 1998). In this report and in its latest Annual Review of Development Effectiveness, the World Bank stressed that its project-failure rate is still high, even though it has declined over the last two years. Project failure is attributed to benign neglect in the area of institutions and to a lack of appreciation of the role played by incentives in public organizations. Strong institutions, including legal systems, government bureaucracies and arrangements for supervising and monitoring banks and protecting property rights have come to be seen as essential for economic development and social stability. Yet, only 40% of the projects financed by the World Bank have a substantial impact on the development of institutions.

The assessment of the World Bank is that a combination of policy dialogue and financing is more likely to increase the effectiveness of aid than a narrow focus on successful implementation of aid-funded projects. The World Bank recognizes that development assistance has not paid sufficient attention to the effectiveness of public institutions. Aid has gone almost exclusively to — or through — central governments (which are the recipients of the loans or provide a financial guarantee for regional and local governments or public-service providers), but not enough attention was devoted to the incentive and institutional aspects behind public policies.

The role of incentives, which has been underestimated until recently, is recognized in three major areas. In order for public services to be provided efficiently, stakeholders, i.e. the government, the provider (private or public) and the citizens, must have the right incentives. Local stakeholders must have a sense of ‘ownership’ of the project, which implies more participation by the community and greater accountability of officials. Such a view means that donors must change their focus “from project to process” and *inter alia* assess the likelihood that this process will generate sustained benefits. Second, the report recognizes the power of incentives in determining the actions of government officials and public sector providers. This implies fighting corruption and ensuring that civil servants are well paid and well trained. Third, the report recognizes the importance of good public policies and good incentive structures in public organizations.

In countries where policies and institutions are seriously weak, the Bank would do best not to lend and to focus on ‘non-lending services’ (policy advice) that support the strategic policy-making and implementation capacity of governments. In intermediate cases ‘policy-based lending’ is an option. Reform-minded governments will be open to the ideas proposed by the international community. Non-reform-oriented governments that defend the status-quo and oppose needed reform should not receive concessional aid for ‘development’ or have access to World Bank loans. This implies that they have to pay a risk premium on private international capital markets, if they can access them. On the basis of a careful examination of the impact of aid, the report suggests that project funds are wasted in countries with governments that have consistently had the wrong policies or kleptocratic political systems. The report therefore advocates concentrating on policy advice and on balance-of-payment support, contingent on the implementation of specific changes in policy. It stops short of a recommendation to reorient World Bank lending to the private sector or to stop lending to the public sector or to publicly guaranteed projects, even in cases where private providers are perfect substitutes for public providers. This is because, otherwise, the international community would have no means of influencing public goods such as the rule of law or goods that have major externalities such as health care or environmental protection in countries that have weak institutions and inefficient governments.

Knowledge and policy advice are generally international public goods. Even “rogue nations” and the basket cases of the world are allowed access to it. The problem, however, is that their governments are precisely those which are very unlikely to use the knowledge and advice of the international community. Limiting (or blocking) those governments’ access to World Bank funds and forcing them to borrow at punishingly high rates on private markets does little to change the internal politics of the country or to alleviate poverty there.



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