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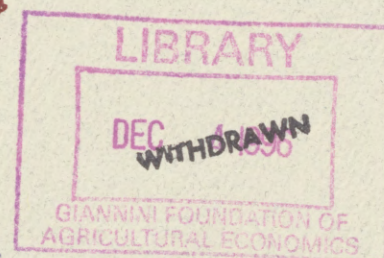
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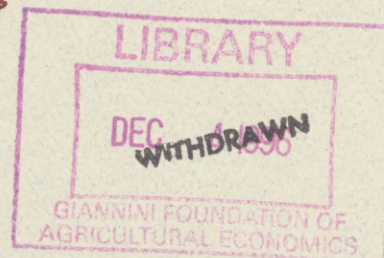
Robert H. Bates

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Institutions as Investments

by

Robert H. Bates

Capital markets furnish a fertile source of non-market institutions. In such markets, present costs are incurred for future benefits, and private agents are therefore vulnerable to opportunistic defections. They therefore have strong incentives to innovate agencies of constraint, as by creating and structuring political institutions.

Applying the logic of the "new institutionalism," the paper focuses on the political reforms that have taken place since the debt crisis. It argues that many of these reforms represent attempts to restructure domestic political institutions in a way that will secure re-admission to international capital markets.

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Institutions as Investments*

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Robert H. Bates

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Introduction

Among the varieties of modern political economy, two stand out. They can be characterized as the "Madisonian" and "Hamiltonian." The Madisonian approach borrows from economics the postulates of rational choice and the methods of equilibrium analysis, which it applies to political institutions, and, in particular, to those characterized by majority rule. The Hamiltonians also borrow their tools from economics. But, to a far greater degree, they emphasize the interaction between politics and economics. They focus on the impact of politics upon the economy and, in particular, upon economic development.

The Madisonians explore the way in which rational self-interest interacts with institutionalized rules of the political process so as to shape the making of public policies.¹ the implications for politics. Thus Anthony Downs explores the impact of the rational pursuit of electoral majorities upon politicians' choice of public policies.² And David Mayhew shows how Congress is structured so as to secure flows of policy choices that

* I wish to thank Karen Ferree, Kenneth Shepsle, Smita Singh and participants at the Conference on The Political Dimensions of Economic Growth held in San José, Costa Rica, March 31 - April 3, 1996 for their comments on this paper. I alone am responsible for the errors that remain.

¹ As argued by Madison himself, "if men were angels, no government would be necessary." Given that they are not, the art of government then becomes the art of structuring ambition such that it counters ambition, thereby defending the collective against the private interest of politicians. See "Federalist 51" in The Federalist (New York: Modern Library, 1937), pp. 337ff.

² Anthony Downs, An Economic Theory of Democracy (New York: Harper and Row, 1957).

systematically enhance the re-election chances of incumbents.³ Only, perhaps, in the hands of those interested in industrial regulation do the Madisonians look at the impact of politics upon economics;⁴ and only, perhaps, in the hands of those who study campaign financing do the Madisonians look at the impact of economics upon politics.⁵ For, like their progenitor himself, modern Madisonians are interested in politics qua politics. It was Hamilton, not Madison, who focused on the impact of politics upon the economy, and, in particular, with capital markets.

Hamilton sought to create a government that would promote domestic manufacturing and industry, attract foreign capital, and inspire sufficient confidence among those with savings that they would purchase the government's debt at low rates of interest. Madison studied the arts of government for their own sake; Hamilton focused upon the role of government in strengthening public finances and in promoting economic growth.

Like the Madisonians, the Hamiltonians come in many guises. Douglass North stands as among the most illustrious exemplars of this tradition; it is North who focused scholarly attention upon the economic impact of political institutions.⁶ The theme has been taken up by others. Weingast explores the impact of political institutions upon the mobilization of public savings.⁷ Hoffman and Rosenthal explore their impact upon

³ David Mayhew, Congress: The Electoral Connection (New Haven and London: Yale University Press, 1974).

⁴ For a review, see Roger Noll, Regulatory Policy and the Social Sciences (Berkeley and Los Angeles: University of California Press, 1985).

⁵ See, for example, Gary Jacobson and Samuel Kernell, Strategy and Choice in Congressional Elections (New Haven and London: Yale University Press, 1981).

⁶ Douglass North, Structure and Change (New York: Norton, 1981).

⁷ Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth Century England," in Monetary and Fiscal Policy: Vol. 1, Credibility, ed. Torsten Persson and Guido Tabellini (Cambridge: The MIT Press, 1994).

incentives to improve or invest.⁸ And Alesina, Barro and Londregan and Poole explore their impact upon economic growth.⁹

In this essay, I seek to extend the Hamiltonian tradition. In the modern era, states throughout the globe have attempted to restructure their economies so as to enhance their standing in international capital markets. They have also sought to restructure their political institutions. I seek to advance the Hamiltonian perspective I by exploring the interaction between the search for capital and these reforms. In pursuit of first principles on which to base my analysis, I first turn to the problem of time consistency. Modern political economy has proposed a series of solutions to that problem, and I explore their implications for the creation of non-market institutions. I then turn to the implications of this analysis for the reform of political institutions, as nations, buffeted by the debt crisis, sought renewed access to capital markets.

The Fact of Time

Capital requires exchanges over time. To form capital, people save. Withholding goods from consumption in one period, people invest, such that they can enhance their consumption in future periods. The prospects of future rewards motivate sacrifices in the present. Lying in the future, the prospective rewards are uncertain, however. Among the risks are those of non-performance, or opportunistic actions by other human beings. In the

⁸ Jean-Laurent Rosenthal, The Fruits of Revolution, Property Rights, Litigation and French Agriculture: 1700-1800 (Cambridge: Cambridge University Press, 1992); Philip T. Hoffman, "Institutions and Agriculture in Old Regime France," Politics and Society 16, nos. 2-3 (1988):

⁹ Alberto Alesina and Dani Rodrik, "Distribution, Political Conflict, and Economic Growth," in Political Economy, Growth and business Cycles, ed. Alex Cuikerman, Zvi Herowitz, and Leonardo Leiderman (Cambridge: The MIT Press, 1992) and Alberto Alesina, Sulke Özler, Nouriel Roubini, and Phillip Swegel, "Political Instability and Economic Growth," typescript, Harvard University, November 1993; Robert J. Barro, "Democracy and Growth," NBER Working Paper No. 4909, October 1994 and "Economic Growth in a Cross Section of Countries," Quarterly Journal of Economics (May 1991): 407-443; and John Londregan and Keith Poole, "Poverty, the Coup Trap, and the Seizure of Executive Power," World Politics 42, 2 (January 1990): 151-84.

face of such risks, individuals may fail to make investments that would render them -- and, indeed, all people -- better off. I argue in this paper that the desire to transcend this dilemma motivates the creation of non-market organizations, including political institutions.

The basic problem is captured in the following diagram (Figure 1). Player 1, who can be thought of as a private investor, moves first and chooses whether or not to invest (negation is signified a tilde, \sim ; investing is signified by a the letter I). Should Player 1 invest, Player 2 must then decide whether or not to perform (signified by P and $\sim P$). Player 2 can be thought of as another private agent, such as a manager or employee, whose performance will influence the financial returns from the investment. Alternatively, Player 2 can be thought of as a government, whose policies can affect the value of the investment. In the diagram, each player ranks the outcome from best (1) to worst (3), with Player 2's ranking listed second. As can be seen, should Player 1 invest, Player 2 can benefit from behaving opportunistically; if a government, Player 2 could, for example, confiscate the assets invested by Player 2. Knowing that, Player 1, will choose not to invest, with the result that both players are worse off. Player 1 -- an investor -- therefore possesses an incentive to find means of constraining the behavior of Player 2 -- be Player 2 another private agent or a government. More subtly, Player 2, the potential opportunist, possesses incentives to restrain herself; should she be able to do so, Player 1 would then invest, and Player 2 would escape her least preferred outcome. Both could therefore be made better off were Player 2 able to commit to not behaving opportunistically. Both could be made better off were Player 2 able to tie her own hands. Consistent, period by period optimization thus generates outcomes that are not either privately or socially optimal.

Capital, being central to growth, is central to the process of development. Being inherently inter-temporal, capital formation runs afoul of the problem of time consistency. In this paper, I therefore focus on how the desire for investment, capital formation, and growth motivate the creation of non-market institutions. In particular, I argue that the political restructuring of capital markets that accompanied the recession and debt crisis of the 1980s can be interpreted as attempts to form institutions that would address the problem of time consistency. The analysis I advance rests upon the "new institutionalism" in political

economy.¹⁰ But the analysis resonates with themes long ago advanced in the classics of Marx, Weber, and other students of the rise of capitalism and the creation of industrial economies.¹¹

Culture

There are, of course, many kinds of capital. For this discussion, we can distinguish between capital in commerce and in industry. Commercial capital underpins the exchange and distribution of a flow of shipments which can often be subdivided into discrete lots of a near continuous distribution of sizes. It often takes the form of short term credit and occurs in an environment of multiple transactions. The creation of industry more often requires long term investments. It often takes place in an environment that may require a single, large commitment of investible funds; the investments are often "lumpy" and discrete. Industrial investment may therefore be thought of as the creation of a capital stock which is either on -- and so producing revenues -- or off -- and so incurring costs that are fixed. The larger the investment, the higher the fixed costs. In this section, I argue that informal organizations, such as communities, can support commerce and trade; that significant savings requires a special kind of culture, which I will call the culture of abstinence; but that neither community nor culture can support the creation of industrial capital.

Exchange in markets characterizes virtually all societies. Commerce and trade antedate the rise of capitalism. Despite the arguments of many,¹² exchange in markets characterizes virtually all societies. Archeological evidence documents its prevalence in pre-

¹⁰ John Harriss, Janet Hunter, and Colin M. Lewis, The New Institutional Economics and Third World Development (London: Routledge, 1995).

¹¹ Marx and Engles, Capital (London: Dent, 1957); Max Weber, Economy and Society (New York: Bedminster Press, 1968). See also Allan Richards, Development and Modes of Production in Marxian Economics (New York: Harwood Academic Publishers, 1986).

¹² Especially the devotees of Karl Polanyi. See Karl Polanyi, The Great Transformation (Boston: Beacon Press, 1977).

historic times.¹³ Anthropological evidence puts the lie to the myth of self-sufficiency, even in peasant societies.¹⁴ And the importance of black markets and corruption in communist states underscores the significance of trade even in centrally planned economies.

Trade requires capital: it involves exchanges separated by time, as goods are placed on consignment or as payments await settlement. The possibility of opportunism therefore arises. Promises to repay may be made, but the temptation to defect remains. As illustrated in Figure , the result of this temptation is less trade than either party would prefer. When trade flourishes, it would appear, it is because it is protected. Non-market institutions help to underpin commercial exchange.

An example is provided by long distance trade in Western Africa. Cattle are raised on the savanna, away from the diseases that reside in the coastal forest; people on the coast, however, enjoy consuming meat. Kola nuts are grown in the forest but also enjoyed by the inhabitants of the savanna, who consume them as a stimulant. The result of different endowments is the flow southward of cattle for slaughter in the towns of the coastal forest and the flow northward of kola nuts for consumption by the inhabitants of the savanna. The trade requires credit: until the kola is sold, debts incurred in purchasing cattle cannot be paid by merchants in the south. But creditors face the risk of non-payment, therefore putting the market itself at risk.

As analyzed by Avner Cohen,¹⁵ the Hausa traders formed an ethnic and religious organization that acquired a relative advantage in this valuable trade. Organized in communities -- the sabon garri -- in the coastal towns and in mosques in the savanna, Hausa merchants imbedded their commercial transactions within dense networks of communal relationships. Within their communities, individual merchants were able to build reputations

¹³ Book on risk. Acqui.

¹⁴ See, for example, the evidence on off-farm sources of income in peasant societies in Kenya from the surveys conducted by the Central Statistical Office. References are contained in Robert H. Bates, Beyond the Miracle of the Market (Cambridge: Cambridge University Press, 1991).

¹⁵ See Avner Cohen, Custom and Politics in Urban Africa (Berkeley and Los Angeles: University of California Press, 1969).

for probity; as their word became their bond, their reputations acquired value as a source of low cost credit. And the threat of exclusion from the low cost credit accessible through their community rendered the short term gains from defection financially unattractive.

People who emitted the signs of probity, and so became persons of good standing in the community, signal that they would behave in trustworthy ways.¹⁶ They will not dissipate resources, their deportment proclaims. They will behave honorably, keeping their word and repaying their debts. They comport themselves in ways that affirms their sobriety; they became "bankable." For the community, the result is a greater ability to form capital.

The case of the Hausa is replicated by analogous cases elsewhere: the overseas Chinese, for example, in South East Asia¹⁷; the Lebanese in West Africa¹⁸ or the Jews in early modern Europe. In such settings, a creditor (Player 1, in the terms of Figure 1) could be assured that a debtor (Player 2) would not defect, for fear of the subsequent future losses she would then incur. Confident in that knowledge, Player 1 would therefore offer credit to (choose I), knowing that Player 2 would perform (choose P). These cases therefore illustrate how repeated interaction enables the creation of reputations, whose value constitutes an incentive for non-opportunistic behavior.

While in any trading network the total quantity of commercial capital may be large, a given individual's exposure to risk may in fact be fairly small. If not paid for, goods may be repossessed; a given stock of goods may be distributed among several trading clients, reducing the costs of a single defection. Facing little individual risk, people may be willing to advance credit to merchants even in relatively profligate societies. When, however, individuals seek to save significant amounts and dedicate their savings to specific enterprises or individuals, then they face higher levels of risk. The result, it would appear, is a demand for higher levels of assurance. One response is the creation of a culture of abstinence.

¹⁶ For a discussion, see Eric Rasmusen, Games and Information (London: Blackwell, 1989).

¹⁷ See Janet Janda, "Underground Economies," in Beyond the Informal Sector ed. Jerry Jenkins (San Francisco: The Sequoia Institute, 1988); The Economist, March 9 1996.

¹⁸ See P. T. Bauer, West African Trade (London: Routledge and Kegan Paul, 1963).

Studies of villages in Central Africa provide an apposite example. As do villages elsewhere in the developing world, those in Central Africa contain a culture of generosity. Emphasizing the importance of hospitality, people use their savings to brew beer, provide food, and finance feasts for family members and friends. To be a member of the community in good standing, one has to reciprocate the generous acts of others.

People who spent money entertaining others found it difficult to save, however. They found it difficult to accumulate the resources with which to form capital, as by investing in the education of their children. As industry expanded, government grew, and the returns to education therefore increased, so too did the costs of failing to save and so finance the costs of education. The response, anthropological investigators noted, was the creation of an alternative to the beer culture.. Joining the Watchtower society or the Adventists, those seeking to advance in the new social order invested in a culture of abstinence.¹⁹ Their propaganda featured portraits of the converts: smartly clad adults, with white shorts, ties, or modest dresses; seated at tables, with cutlery and table cloths; in tidy houses, with calendars on the wall, books and newspapers on the tables -- and the fathers eating at home.

Those who study the villages of Central Africa stress that villagers seeking to abandon the beer culture not only acquired new, highly visible life styles. The "improvers" or the "accumulators," as others have called them,²⁰ also built communities. The converts constructed new churches, schools, and other facilities outside of the existing communities, and moved their families to the village that they had constructed. By constructing communities, they took steps that rendered them -- and the ones they loved -- hostages to their new life style. By joining such communities, they made themselves vulnerable to social sanctions that would reduce the benefits of opportunistic behavior.

¹⁹ Norman Long, Social Change and the Individual: A Study of Social and Religious Responses to Innovation in Zambia (Manchester: Manchester University Press for the Institute for African Studies of the University of Zambia, 1978)

²⁰ To use the terminology of Kitching and Cowen on their work in Kenya. See Gavin Kitching, Class and Economic Change in Kenya (New Haven and London: Yale University Press, 1980) and Michael P. Cowen, "Capital and Household Production," Ph.D. Dissertation, University of Cambridge, 1978.

Returning once again to Figure 1, we can gain insight into the consequences of this behavior. In effect, by committing to life in a community, Player 2 renders herself vulnerable to retaliation. By investing in a long-term relationship with Player 1, Player 2 converts the relationship from a two-period to a multi-period interaction. Should the interaction persist over a life time, or be of uncertain duration, were she to renege on promises, the short-term gains from defection could be bought only at the price of a long-term stream of penalties, inflicted by Player 1. As the future losses could, for many reasonable rates of discount, outweigh the benefits of opportunistic behavior, Player 2 would not choose to behave opportunistically. Player 1 can therefore be assured that Player 2 will behave responsibly, and not sacrifice the long term gains by optimizing myopically.²¹

In the spirit of Weber, I therefore begin by focusing on the role of culture and of community.²² The culture of capitalism has been addressed by Weber himself but also by economic historians, such as Hoffman; by cultural historians, such as Schama; and by novelists, such as Balzac and Dickens.²³ Probity, discipline, rectitude, solidity, reliability, trust, they argue, smother the Dionysian impulses that threaten the ability to save. Behaving transparently, and comporting oneself soberly and with gravitas: these ways of signaling such traits constitute appropriate behavior both in the board room and on mainstreet. They

²¹ One of the most lucid presentations of the use of trigger or punishment strategies is contained in Robert Barro and David B. Gordon, "Rules, Discretion, and Reputation in a Model of Monetary Policy," in Monetary and Fiscal Policy, Vol 1: Credibility, ed. Torsten Persson and Guido Tabellini (Cambridge: MIT Press, 1994).

²² Max Weber, The Protestant Ethic and the Spirit of Capitalism (London: G. Allen and Unwin, 1965).

²³ Philip T. Hoffman, Church and Community in the Diocese of Lyon, 1500-1789 (New Haven and London: Yale University Press, 1984); Simon Schama, The Embarrassment of Riches (New York: Knopf, 1987); Honorre de Balzac, The Alchemist (New York: Rudd and Carleton, 1861); Charles Dickens, Bleakhouse (London: Bradbury and Evans, 1853). See also Thomas Haskell and Richard Teichgraber III, The Culture of the Market (Cambridge: Cambridge University Press, 1993).

represent means for building trust in environments in which value can be lost unless people restrain their impulses, adhere to agreements, and honor their pledges.²⁴

Culture and community offer only limited means of safeguarding exchanges over time, however. They will not suffice for the formation of certain types of capital, or in settings characterized by asymmetries of power.

One reason is that they rely for their effectiveness on repeated interaction. But many investments do not involve repeated interactions. Some are lumpy, as in the case of large construction projects. Others involve fixed and specific capital: valuable in one use only, they are vulnerable to subsequent "hold ups" or opportunistic exploitation. Investors in such ventures cannot foresee possibilities for future interactions and therefore can not rely on the use of "repeated play" as a means of defending their interests. The mechanisms that lodge in culture and community therefore offer them little re-assurance.

In addition, such informal mechanisms are vulnerable to asymmetries in power. If Player 2 could, at low cost to himself, expropriate the resources placed at risk by Player 1, then were he to assume a pious garb and life style, it could reasonably be construed as dissimulation. He could reasonably be regarded as pursuing a strategy of ingratiation, lulling his partners before preying upon them. Such, for example, was the way in which village communities in West Africa regarded the Aro.²⁵ In the conflictual and tumultuous politics of the 19th Century, when a village affiliated with the Aro cult, then its proselytizers would enter, purging it of criminals and idlers, dispensing justice, and restoring order. On the one hand, the cult was valued for the order it could bring. On the other, the Aro were profoundly distrusted. For while the cult fortified and defended norms of respect for life and property, it also possessed the power to extort. The ingratiating proselytizing of its missionaries was

²⁴ See, for example, David Kreps, "Corporate Culture and Economic Theory," in Perspectives on Positive Political Economy, ed. James Alt and Kenneth Shepsle (Cambridge: Cambridge University Press, 1991).

²⁵ See David Northrup, Trade Without Rulers (Oxford: Clarendon, 1978) and Simon Ottenberg, "Ibo Oracles and Intergroup Relations," Southwestern Journal of Anthropology 43 (1958): 295-317.

therefore treated with the deepest skepticism. And the cult failed to create a stable environment for the development of the region.

Interpersonal cue giving and long-term relationships thus provide support for intertemporal exchanges. But the exchanges they promote seem better to safeguard highly divisible flows of capital than one-off, specialized investments. Communities of rectitude may underpin the prosperity of commerce.²⁶ In both history and in the contemporary world, we frequently find commercial networks lodged within religious and ethnic communities.²⁷ But culture and community provide a fragile foundation for the creation of heavy industry, which often requires lumpy, fixed or specialized investments. While we everywhere encounter trade and markets, we far less frequently encounter industrialization or capitalism. The promotion of industrial investment requires other forms of defense, and other means for correcting the perverse incentives arising from period by period optimization in intertemporal settings.

Vertical Integration

Culture and community provide defenses against opportunism in decentralized settings. But, in the creation of fixed assets, those seeking to transcend the dilemma outlined in Figure 1 may seek to move transactions out of markets and embed them in authority structures. Viewed through the lens of economic reasoning, this solution can be seen as the creation of the firm. Fisher Body provides the classic example.²⁸ General Motors, the largest auto maker in the world, purchased auto bodies from Fisher. But the two firms then encountered the problem outlined in Figure 1. To supply auto bodies to General Motors,

²⁶ See Avner Cohen, Custom and Politics in Urban Africa (Berkeley and Los Angeles: University of California Press, 1969).

²⁷ See, in addition, Claude Meillassoux, ed. The Development of Indigenous Trade and Markets in West Africa (London: Oxford University Press for the International African Institute, 1971).

²⁸ See the classic work of Benjamin Klein, Robert Crawford, and Armen Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," Journal of Law and Economics (1978): 297-326.

Fisher had first to invest in the creation of lumpy, expensive, highly specific capital; valuable only in this use, the specialized machines and dies were without significant value in any other. The market provided insufficient safeguards: Fisher was reluctant to make the necessary investments for fear that General Motors would subsequently behave opportunistically, re-negotiate the terms of its contract, and expropriate the quasi-rents that inhered in its industrial capital.²⁹ The solution was to move the transaction out of the market and into the firm. General Motors purchased Fisher.

When viewed through the lens of political theory, the solution can be thought of as the creation of a state, or, in Mancur Olson's phrasing, of a "stationary bandit."³⁰ A state, or a stationary bandit, possesses sufficient power to gain uncontested "ownership" of the streams of income generated by private agents. As argued by Olson, the stationary bandit thereby acquires a stake in the prosperity of that region. The streams of income that flow from the region become part of his endowment, enabling the bandit to prosper. And the asymmetry in power that bedevils the use of informal mechanisms, such as the community, pose less of a threat to the formation of capital. The alternative, in Olson's phrasing, is to be a "roving bandit." The roving bandit possesses little incentive to conserve; the goods he refrains from dispoiling will be harvested by others. In Olson's colorful language, the roving bandit will therefore behave as a wolf; the stationary bandit, as a shepherd. Both will consume from the flock, but only the second possesses an incentive to defend and to nurture.

²⁹ See the literature on industrial organization and, in particular, Oliver Hart, Firms, Contracts, and Financial Structures (New York: Oxford University Press, 1995); Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," Journal of Financial Economics 3 (1976):305-60; and Oliver Williamson, The Economic Institutions of Capitalism (New York: Free Press, 1985). See also Paul Joskow, "Vertical Integration and Long Term Contracts: The Case of Coal Burning Electrical Generating Plants," Journal of Law, Economics, and Organization 1 (1) (1985):33-80.

³⁰ Mancur Olson, "Dictatorship, Democracy, and Development," American Political Science Review 87, 3 (September 1993):567-76. For an analogous argument, see Andrei Shleifer and Robert Vishny, "Corruption," Quarterly Journal of Economics (1993):599-617.

In terms of the above diagram, both solutions can be seen as restructuring the ownership of the payoffs. The external costs that Player 2 -- General Motors in the previous example; the state, in this -- could inflict on Player 1 -- Fisher Body, in the previous example; the private sector, in this -- would now accrue to Player 2. By acquiring ownership, Player 2 internalized these costs. Out of its own self interest, Player 2 will now choose to perform, rather than to defect; behaving rationally, it will not behave opportunistically. With the change in ownership, incentives thus alter, weakening the tendency for period by period optimization and strengthening the ability of persons to implement longer term plans.

The relevance of this argument for development is underscored by Leith and Lofchie's account of the economic collapse of Ghana. Following the coup that toppled the Nkrumah government, Leith and Lofchie argue, political control in Ghana remained highly contested. As a consequence, those in power had little incentive to conserve, rather than consume; indeed, they treated the economy like a common pool resource, over which they possessed ill defined ownership. Ghana's successive governments therefore extracted resources from export agriculture at too high a rate, not paying heed to replenish the capital stock. Leith and Lofchie thereby explain the apparently irrational "over grazing" of Ghana's cocoa-based economy -- the legendary killing of the goose that laid the golden egg and trace it to a lack of "political ownership."³¹

The case of Ghana thus illustrates the importance of Olson's arguments. The analogy with vertical integration illustrates its logic. Vertical integration in industry and state formation in politics: both define a structure of ownership that elicits private choices that support efficient inter-temporal decisions. By lodging the payoffs within the utility function of an appropriate actor, they transform incentives and thus its behavior in inter-temporal settings.

³¹ My phrase, not theirs. Clark Leith and Michael Lofchie, "Ghana," in *Economic and Political Interactions in the Process of Policy Reform*, ed. Robert H. Bates and Anne O. Kreuger (Oxford: Blackwell, 1994). See also Londregan and Poole, "Poverty, the Coup Trap, and the Seizure of Executive Power."

Viewed more broadly, the argument is this section helps to explain why industrialization requires not just culture and community, but also institutions. While the informal sanctions of interpersonal behavior and community may support the kind of repeated intertemporal transactions encountered in commerce and trade, they are insufficient for investments in fixed, lumpy, and specialized capital, or investments in settings in which some hold coercive power and others do not. Modern capitalism may arise in certain cultures; its "spirit" may be transmitted by particular communities. But it also requires institutional defenses. Firms or states constitute the institutional foundations for the modern industrial economy.

It is difficult systematically to test the argument regarding firms. Rather than appealing to statistical data, we must instead appeal to the evidence of historians. Some, such as Weber, stress that businesses form bureaucratic organizations, with structures of authority and "rational-legal" forms of discipline.³² Others analyze the modern economic history of the United States in terms of the rise of large corporations.³³ Still others, such as Gabriel Kolko, focus in particular on the creation of governance structures that render possible investment in large, fixed cost technologies.³⁴ Kolko traces both the rise of large firms and the regulatory state to the growth of North American capitalism.

For the relationship between the state and economic growth, we do, fortunately, possess more abundant evidence. In his early classic, Robert Barro attempted to account for cross-national variation in the rate of growth in real per capita incomes for 98 countries over the period 1960-85.³⁵ Measures of economic instability -- or, more freely interpreted, of the presence of roving bandits -- significantly and negatively related to the rate of economic growth when entered with other variables in the now-standard conditional growth equation.

³² Max Weber, Economy and Society (New York: Bedminster, 1968).

³³ Alfred Dupont Chandler, The Visible Hand: The Managerial Revolution in American Business (Cambridge, MA: Belknap Press, 1970).

³⁴ Gabriel Kolko, Railroads and Regulation (New York: Norton, 1970).

³⁵ Robert Barro, "Economic Growth in a Cross Section of Countries," Quarterly Journal of Economics (May 1991): 407-43.

Moreover, the same variables -- measures of the frequency of revolution, coups, and assassinations -- significantly and negatively related to the level of private investment in the economy, as did the level of government consumption -- which can be interpreted as the redistribution of resources from the private sector to a "predatory" state.³⁶

Other recent studies have strengthened and clarified Barro's initial findings. Alesina and Perotti, for example, seek to control for the bias introduced into Barro's analysis by the simultaneous relationship between economic and political factors. Rates of investment, they reason, may be a cause of, as well as being affected by, levels of political instability.³⁷ Employing two-stage least squares, they therefore relate cross-sectional variation in the rate of total investment to cross-sectional variation in the levels of political instability for a sample of 71 countries 1960-1985. Even taking into account the impact of investment on political instability, they find that increased instability significantly depresses the level of investment in their sample set of countries. Borner, Brunetti, and Weder collected the assessments of a sample of entrepreneurs of the degree of risk and policy instability in a sample of 28 countries. When entered into a standard growth equation, the private investor's assessment of political risk helped to account for nearly half the cross-country variation in the rates of economic growth, 1980-1990.³⁸

Changes in the State: Part I

Vertical integration and state formation alter incentives by transforming the structure of ownership. By transforming the structure of ownership, the actors seek to align their incentives such that if Player 2 fails to honor her pledge to perform, she will herself

³⁶ Ibid., pp. 431 and 437.

³⁷ Alberto Alesina and Roberto Perotti, "Income Distribution, Political Instability, and Investment," Typescript, Harvard University, October 1991. But see the contrary evidence contained in John Londregan and Keith Poole, "Poverty, the Coup Trap, and the Seize of Executive Power," World Politics 422 (January 1990): 151-83.

³⁸ Silvio Borner, Aymo Brunetti, and Beatrice Weder, Political Credibility and Economic Development (New York: St Martins, 1995).

experience the harm she inflicts. Nonetheless, there remains the potential for losses of welfare. A problem of agency arises because the alignment of interests will not be perfect. While Player 2 may not expropriate resources arbitrarily, she may nonetheless fail to convert them into outputs that will be valued by Player 1 as highly as the stream she could have generated had she put the resources to other use.

This problem of agency is addressed in a literature that is too broad, and often too technical, to be reviewed here.³⁹ More relevant for political scientists, rather, is the line of analysis extracted from that literature by Kathryn Firmin-Sellers, in the case of Ghana, and North and Weingast, in the case of England.

In a fascinating study, Firmin-Sellers analyzes the pre-independence political history of the Akyem Abuakwa, the traditional state of the Akyem, a people who live in the coastal forest of Ghana.⁴⁰ Because of their ecological endowment, the Akyem could produce abundant cocoa at low cost; and because of their geographical location, they could readily export it to world markets. But cocoa production requires high fixed costs: the forest has to be cleared, trees planted, and subsistence sustained for 3 to 4 years before the first crop can be harvested. Private agents therefore required that their rights to the stream of future income be assured before they would invest in the establishment of cocoa plantations. They also required public investments in roads, bridges, and transport facilities.

In the provision of property rights, Firmin-Sellers notes, the Akyem were favored by the existence of a government that possessed uncontested hegemony over the region. Craftily manipulating the British imperialists, Nana Offori Attah, the "king" of the Akyem, ensconced himself in power. Under his leadership, the government of the Akyem gained a monopoly jurisdiction over the forest territory and the revenues originating from taxation of the exports from the forest. In Olson's terms, the government of the Akyem became a stationary bandit. The problem, however, was that while the government acquired an interest

³⁹ For a review, see Paul Milgrom and John Roberts, Economics, Organization, and Management (Englewood Cliffs, NJ: Prentice Hall, 1992).

⁴⁰ Kathryn Firmin-Sellers, "The Politics of Property Rights," American Political Science Review 89, 4 (December 1995):867-881.

in the prosperity of the cocoa industry, it remained a less than faithful agent of those who invested in it. It might not extract too high a level of tax revenues, but how would it spend them: on salaries and perquisites, or on infrastructure? On the multiplication of office holders and hangers on, or on services for the community? Law suits highlighted the degree of distrust between the people and their chiefs. So too did the low rate of payment of taxes to the government, and the slow rate of capital formation in the cocoa industry.

The Akyem thus confronted a major possibility for riches, were investments to be made in cocoa production. What was required, Firmin-Sellers argues, was that the "stationary bandit" first convince investors that it would extract revenues in a rational manner and employ them productively. Nana Offori Attah addressed this problem by creating a new political structure: a form of local government called the Native Treasury.

In this structure, those who took the risks of investing -- the private sector -- received seats in a governing council; the monarch then served as their executive. Under this new form of government, then, the monarch gave away power; rather than remaining a principal, he reduced himself to an agent. The principal became the political representative of the private sector, including the owners of cocoa farms.

The reorganization of the government of Akyem Abuakwa represented, Firmin-Sellers argues, an attempt to give assurances to private investors that the executive would act in ways that safeguarded their interests. The owners of cocoa farms constituted the residual claimants of the industry; payments to factors -- and to the state -- represented claims on their profits. By putting the residual claimants in control of the government, the monarch signaled that he was willing to behave in ways that safeguarded their profits, both by limiting the level of taxation and insuring that revenues would be spent in ways that enhanced the future of the industry. Firmin-Sellers presents evidence that the reforms worked. The level of tax revenues paid to the government of the Akyem appears to have increased following the reform. And, certainly, the export economy boomed during the reign of Nana Offori Attah.

North and Weingast advance a similar argument. In their now classic article on the Glorious Revolution, they stress an important irony: that, by giving away his capacity for discretion, the monarch in fact strengthened his power. Monarchs, they argue, needed to finance wars; they therefore needed revenues, be it in the form of loans or taxes. But lenders

feared that monarchs, being sovereign, would exploit their ability to default with impunity and tax payers feared that, if well financed, the monarch would commit to ventures that would lead to yet further claims on their resources. The Glorious Revolution is often treated as strengthening Parliament and weakening the monarchy; but, North and Weingast counter, it in fact led to a far stronger executive as well. For by giving Parliament the power over public revenues, the monarch signaled his commitment to use private resources in ways that would be consistent with the objectives of those who contributed them. The result, they argue, was that Britain's "weak state" in fact gained greater access to public revenue than did the "strong," executive dominated states of continental Europe.⁴¹ Britain's civilian democracy financed and staffed the most powerful war machine of its era.⁴²

As argued by Olson, when "bandits" secure uncontested domain over the revenues from a territory, they acquire incentives to refrain from despoiling it; to do so would be to reduce their own fortunes. The creation of "stationary bandits" represents a change in the structure of ownership, such that the second moving player -- the predator -- regards the payoffs to the first as his own. The interests of executives and the creators of wealth are never perfectly aligned, however; governments are always less than perfect agents of the people and investors may justifiably worry that governments will seize too much private wealth or make unproductive use of what they extract. As argued by Firmin-Sellers and North and Weingast, the response is to restructure the game. Executives shed portions of their sovereignty. They reorganize the government so as to limit their discretion. Surrendering discretion, the executive (Player 2, in the parlance of Figure 1) now in effect moves first. Forsaking the second move, he can no longer respond to the moves of the other. As seen in Figure 2, the result of this restructuring is that the Pareto Optimal outcome is now

⁴¹ North and Weingast, "Constitutions and Commitment," in Monetary and Fiscal Policy. See also John Brewer, The Sinews of Power: War, Money and the English State, 1688-1783 (Boston: Unwin and Hyman, 1989).

⁴² See also Philip T. Hoffman and Kathryn Norberg, Fiscal Crises, Liberty, and Representative Government (Stanford: Stanford University Press, 1994) and Robert H. Bates and Donald Da-Hsiang Lien, "A Note on Taxation, Development, and Representative Government," Politics and Society 14 (1985): 53-70.

secured as a perfect equilibrium. By surrendering "sovereign" powers, Conference on The Political Dimensions of Economic Growth held in San José, Costa Rica, March 31 - April 3, 1996 the executive gains an enriched tax base, an enhanced flow of public revenues, and readier access to credit in financial markets.

Even more than in previous instances, we lack the data to test the arguments advanced in this section. The seemingly most promising literature -- that on democracy and growth -- in fact disappoints. The political variables most commonly employed refer to the presence or nature of competitive elections rather than to the structure of government;⁴³ when properties of the executive branch are measured, the measures often refer to continuity in office.⁴⁴ Only one paper -- that by Keefer and Knack -- explores the impact upon growth of a measure of "executive constraint." While they state that this "result is in fact encouraging," the coefficient on the variable remains small.⁴⁵ No measure of legislative checks upon the power of the executive appears to have been employed in cross national growth equations, or of the power of private capitalists in the legislature.

⁴³ For a review of this rapidly expanding literature, see Adam Przeworski and Fernando Limongi, "Political Regimes and Economic Growth," typescript 1992 or Aymo Brunetti, "Politics, Institutional Uncertainty, and Growth: Testing Political Variables in Growth Models," Paper Presented at the Conference on The Political Dimensions of Economic Growth held in San José, Costa Rica, March 31 - April 3, 1996.

⁴⁴ See the literature reviewed by Brunetti, "Politics." See also Londregan and Poole, "The Coup Trap," and Alberto Alesina, Sule Özler, Nouriel Roubini, and Phillip Swagel, "Political Instability and Economic Growth," typescript, Harvard University, November 1993.

⁴⁵ Philip Keefer and Stephen Knack, "Why Don't Poor Countries Catch Up?," Working Paper 60, Center for International Reform and the Informal Sector, College Park, Maryland, July 1995, p. 18. See also Stephan Knack and Philip Keefer, "Institutions and Economic Performance: Cross Country Tests Using Alternative Institutional Measures," Economics and Politics 73 (November 1995):207-227.

Changes in the State: Part II

The solution to the problem of time consistency explored by Firmin-Sellers and North and Weingast entails the creation of a corporate body, which in effect is a legislature, that represents the interests of the private sector and that checks the actions of those who hold executive power. An obvious problem, however, is: why could not the executive simply bribe the legislature? By extracting a sufficient proportion of the wealth of a nation, the executive can offer inducements of sufficient magnitude to make it in the legislators interests to collude against the interests of those they govern. The executive can exploit the private interests of the legislators to suborn them.

In a recent article, Soskice, Bates and Epstein confront this problem and advance a possible solution.⁴⁶ The answer, they argue, lies in government by organizations rather than by individuals. In an organization, the policies are chosen by senior leaders and implemented by junior lieutenants. The desire to advance to senior rank creates incentives for juniors to implement the policies of the organization; the power of juniors to block implementation creates incentives for seniors to choose policies that take into account the interests of the next generation. Should the leaders violate a pledge to refrain from confiscating private investments, juniors would find it in their interests to refuse to implement their decisions. They would want resources to "be left on the table" when it became their turn to rule.⁴⁷ Organizations link generations. The power of deputies within them creates incentives for senior leaders to rule in a more far sighted manner than they might otherwise be inclined to do.⁴⁸

⁴⁶ David Soskice, Robert H. Bates, and David Epstein, "Ambition and Constraint: The Stabilizing Role of Institutions," *Journal of Law, Economics, and Organization* 8 (1992):547-61.

⁴⁷ The juniors do not block all consumption choices by seniors as doing so constitutes a violation of the organization's rules; so too does implementing the choices of a senior who while a junior broke the rules. The incentive of ambition can therefore be used to counter the power of greed.

⁴⁸ The argument is based upon an overlapping generations specification.

The argument advanced by Soskice, Bates, and Epstein thus suggests an amendment to the solution advocated by Firmin-Sellers and North and Weingast. What is required is not simply the empowerment of legislatures. Also required is rule by political organizations, in which juniors possess the power to constrain incumbents. While executives may be anxious to suborn legislatures, the next generation of politicians possess incentives to counter their efforts. Should the seniors seek to extract resources at a rate or in a manner that repels investors and despoils the economy, then the juniors will suffer. Empowered by their position in a political organization, they will seek to nullify the efforts of their leaders. The juniors possess a stake in the future of the economy. Linked by organizational ties overlapping generations may rule in ways that appear to be farsighted, and therefore less threatening to investors.

As suggested by Olson, one such organization would be a dynasty, in which monarchs might be induced to safeguard the interests of their successors.⁴⁹ As analyzed by Huntington, a more contemporary solution is a political party, in which incumbents might be induced to protect the interests of future politicians, whose labor may be critical to the organization and thus to the incumbents themselves, and whose political chances would depend upon the incumbent's policy choices.⁵⁰ As Huntington argues, the interests of political organizations thus define the "public interest," ascribing a greater level of importance to the future than is possessed by individual politicians.⁵¹

Changes in the State: Part III

In an effort to exhibit its willingness to refrain from short term temptation, executives may therefore restructure governments, conferring upon political representatives of the private economy and the next generation the power to shape or counter their choices of

⁴⁹ Olson, "Dictatorship, Democracy, and Development."

⁵⁰ Samuel P. Huntington, Political Order in Changing Societies (New Haven and London: Yale University Press, 1968).

⁵¹ Note the contrast in the public spirited polities that are governed by institutions and the nature of Praetorian politics, which is dominated by the pursuit of self-interest. Ibid.

policies. To gain wealth and the power it makes possible, heads of state may thus limit their sovereignty. One way of viewing this transformation is as the abandonment of discretion.⁵² As illustrated in Elster's famous example, the far-sighted Ulysses tied himself to the mast, so as to elude the sirens' call.⁵³ The image of Ulysses can be interpreted in two ways. One is as the creation of the rule of law; the others is as an act of delegation.

By the creation of the rule of law I refer to the protection of rights in property and the defense of the sanctity of contracts. Keefer and Knack⁵⁴ and others⁵⁵ have related measures of the rule of law to investment and growth in developing societies. They find that in environments where corruption or rent seeking to the arbitrary and discretionary adoption of policies prevail, investors withhold commitments, invest less, and generate lower rates of economic growth. By implication, economies with independent courts and a well developed legal system, in which public servants cannot arbitrarily extract resources from private agents, should provide a more secure environment for investors, and achieve higher rates of capital formation.

By delegation, I refer to the empowerment of technocrats. In the advanced industrial nations, the creation of an independent central bank signals rule governance in the management of the economy.⁵⁶ In nations transiting to a market-based economy, the creation

⁵² A rich discussion is contained in Kenneth Shepsle, "Discretion, Institutions, and the Problem of Government Commitment," in Social Theory for a Changing Society, ed. Pierre Bordieus and James Coleman (Boulder, Colorado: Westview, 1991) and Finn E. Kydland and Edward C. Prescott, "Rules Rather than Discretion," Journal of Political Economy 35, 3 (1977):473-91.

⁵³ Jan Elster, Ulysses and the Sirens (Cambridge: Cambridge University Press, 1979).

⁵⁴ Keefer and Knack, "Why Don't Poor Countries."

⁵⁵ See, for example, Paulo Mauro, "Corruption, Country Risk, and Growth," Quarterly Journal of Economics 110 (1995):681-712.

⁵⁶ See the models reviewed in Torsten Persson and Guido Tabellini, Macroeconomic Policy, Credibility, and Politics (New York: Harwood, 1990). For a discussion of the power of technocrats, see Stephan Haggard and Robert R. Kaufman, The Politics of Economic Adjustment (Princeton: Princeton University Press, 1992); Robert H. Bates and Anne O. Kreuger, Political and Economic Interactions in

of a powerful and cohesive economic team signifies the abandonment of discretion. Both, it is argued, represent ways in which politicians can "tie themselves to the mast" and avoid the temptation of discretionary interventions in markets.

Both arguments have been challenged. The problems with these arguments has been most forcefully captured, perhaps, by Barry Weingast, who writes: "the fundamental dilemma of an economic system is this: A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens."⁵⁷ The rule of law cannot derive its force from the rules themselves; rather, it must derive from the executive's willingness or desire to honor them. In a similar fashion, I have critiqued the argument for delegation.⁵⁸ Economic technocrats, I have argued, are mere academics; they lack either wealth or power. They therefore lack the resources with which to induce or compel governments to abide by their decisions. If they achieve power, it is because government's find it in their interests to confer it upon them. Neither rules nor technocrats possess a force of their own. When they secure deference, it is because the benefits of following them are high or the costs great for failing to do so.

Two solutions to the creation or maintenance of rule-governance suggest themselves. One is short-, the other long-term. Both increase the costs of succumbing to temptation, and so reduce the likelihood of opportunistic predation. Both thus address the political and economic foundations for rule-governed behavior.

The first is drawn from history. In a series of fascinating studies, Hilton Root investigated the tactics employed by monarchs to raise revenues in Early Modern Europe. Monarchs entered capital markets, seeking to borrow at home and abroad. Because, however, they could with impunity default on their debts, potential investors were reluctant

Economic Policy Reform (Oxford: Blackwell, 1993); and John Williamson, The Political Economy of Policy Reform (Washington DC: Institute for International Economics, 1994).

⁵⁷ Barry Weingast, "The Economic Role of Political Institutions," Typescript, the Hoover Institution, September 1992, p. 1.

⁵⁸ In Williamson, The Political Economy of Policy Reform.

to lend, which raised the costs of borrowing. In an effort to gain more favorable access to private capital, Root argues, monarchs therefore created consortia of lenders. In so doing, not only did they lower the risks to the borrowers: each now held a smaller fraction of the public debt. But also they raised the costs to themselves of failing to pay their debts. The monarch could therefore no longer benefit by defaulting on the single (marginal) loan. For the benefits of the default would be offset by the costs of the reprisals taken by all (previous) lenders.⁵⁹ With strong incentives in place to render them trustworthy, the monarch could now borrow more cheaply, and thus gain access to capital.

Faced with opportunistic incentives and the power to act upon them, monarchs confronted limitations on their ability to raise capital. Root shows how they therefore transformed the capital market into an organization, in which they faced a few large borrowers rather than a multitude of small ones. As Root's work suggests, they thus tied their own hands. By organizing an external agency of restraint, they credibly signaled their intention to honor their obligations.

The creation of property rights for investors thus inspires the creation of non-market organizations, such as financial consortia. While not achieved overnight, such solutions can be rapidly organized. In the longer term, other forces come into play. Of these, perhaps the most important is the creation of fixed and specific capital, formed in expectation of the persistence of a rule and dependent for its value upon its maintenance. Put another way, once policy regimes are in place, they acquire vested interests. The power of these interests helps to underpin their stability.

I have discussed a series of ways in which governments seek to signal such commitments: by creating institutional checks, by giving away power to the representatives of investors or the next generation, by organizing costly penalties for their own defection, and so on. Following such commitments, investors should themselves commit, as the

⁵⁹ Hilton Root, "Tying the King's Hands: Credible Commitment and Royal Fiscal Policy During the Old regime," Rationality and Society 1 (October 1989): 240-50 and The Fountain of Privilege (Berkeley and Los Angeles: University of California Press, 1994). See also Avner Greif, Paul Milgrom, and Barry Weingast, "Coordination, Commitment, and Enforcement: The Case of the Merchant Guilds," Journal of Political Economy 102 (1994): 745-71.

threshold level of returns necessary to induce them to do so declines with reductions in the level of risk.⁶⁰

The difference between what they can earn from their investment and its value in its next best use constitutes an incentive for investors to stand and fight: to stand, as the investment is of little value in any other use, and to fight, so as to defend against policy changes that threaten the return to their costly actions. The more specialized the investment, the less reversible it will be. The greater these impediments to mobility, then the greater the incentives to give "voice" in opposition to changes in government policy.⁶¹ Investors can thus acquire a vested interest in the maintenance of a policy.

The formation of fixed and specific capital thus create a domestic lobby for the stability of public policy. It also provides a mechanism that promotes the delegation of policy to technocrats. Technocrats, I have emphasized, lack power: what they possess is expertise. Political elites cannot directly evaluate the quality of their advice; they lack the training to do so. By the same token, neither can they write directly superintend their behavior. Rather than monitoring the behavior of technocrats, political elites may therefore monitor the reaction of political constituents to the technocrat's choice of policies. Investors, locked into programs that are reversible only at great cost, possess strong incentives to raise the alarm when new policies threaten the value of projects into which they have sunk resources. The investment of capital therefore constitutes the creation of a constituency that will not only lobby for the maintenance of the policy but also monitor its implementation.

⁶⁰ Avinash K. Dixit and Robert S. Pindyck, Investment Under Uncertainty (Princeton: Princeton University Press, 1994). See also the literature that views policies as the origins, rather than the determinants, of politics. A stellar example is Paul Pierson, "The New Politics of the Welfare State," World Politics 48, 2 (1996):143-179.

⁶¹ The language is, of course, that of Albert Hirschman, in his classic: Albert O. Hirschman, Exit, Voice and Loyalty (Cambridge, MA: Harvard University Press, 1970).

Given the existence of this constituency of vigilant monitors, politicians can better afford to delegate the management of the economy to those with specialized knowledge.⁶²

The desire to create fixed or specialized or irreversible assets thus promotes the formation of firms and governments. It elicits governmental structures that reduce the risks to capital. And, once such risks are reduced, investment itself creates a lobby in favor of policy stability and rule-governed behavior by political elites. The rule of law, the empowerment of technocrats, the creation of economic and political bureaucracies: these corollaries of the rise of capitalism were, of course, deeply appreciated by Weber and Marx.⁶³ The argument advanced here helps to provide the micro-level logic for the macro-level regularities that they observed.

Conclusion

In the essay thus far, I have drawn on historical materials, by and large: the work of Firmin-Sellers, Root, and North and Weingast. But the problem that motivated Hamilton is as relevant to states in the developing world today as it was to the struggling states of the 18th Century in North America: how to organize so as to attract capital and secure investment.

The recession of the 1970s and 1980s created a crisis in international capital markets. Indeed, following the Mexican default of August 1982, private lending virtually ceased to many portions of the developing world. International donors and financial institutions then began to restructure international markets for capital. In addition, they began to restructure the political institutions of debtor nations. It is interesting to look at the resultant changes in the context of the analysis advanced in this paper.

⁶² Mathew D. McCubbins and Thomas Schwartz, "Congressional Oversight Overlooked: Police Patrols vs. Fire Alarms," in Congress: Structure and Policy, ed. Mathew D. McCubbins and Terry Sullivan (Cambridge: Cambridge University Press, 1987).;

⁶³ Weber, Economy; Marx, Capital.

It is notable that the reconstruction of capital markets has taken "non-market" form, or at least a form that has introduced a high degree of market imperfection.⁶⁴ Under the sponsorship of international financial institutions, lenders have created country consortia, both among private bankers and public creditors. And the international lenders themselves have provided coordinating mechanisms through which to signal to members of these consortia whether the borrower is performing in good faith, or at least in ways that would safeguard his ability to repay. These consortia and arrangements are staffed and run not only by bankers but also by ministers, ambassadors, and businessmen. To promote the flow of capital internationally, they have transformed the market for sovereign debt into a political organization.

The intensity of the protests lodged by developing countries against the international financial community is matched only by the level the aggressiveness with which they seek loans from it. The surrendering of sovereignty is, in the short run, costly; as the diagram suggests, defection, in the short run, pays. It is natural, then, that governments should protest their loss of discretion. But the capacity to defect also imposes costs: lack of access to future streams of capital. It is also natural, then, that governments, in search of capital, should seek means of tying their own hands. Even while protesting, then, borrowers support the efforts of lenders to construct external agencies of constraint. By increasing the costs of exercising their sovereignty, they surrender discretion while enhancing their "bankability." Governments, seeking capital, surrender that discretion, even while decrying the costs, so that they can enjoy the material gains that capital can provide.

Today organizations grow internationally that resemble those created domestically in the past, as states seek to build institutions capable of deterring them from behaving in a predatory fashion. The restructuring of international capital markets has thus taken the form we should expect, given the analysis developed by Root.

As a flood of recent studies has suggested, the crisis of international credit markets has promoted domestic political changes as well. Some have taken the form of changes in

⁶⁴ For a subtle and persuasive analysis, see Charles Lipson, "The International Organization of Third World Debt," in Toward a Political Economy of Development, ed. Robert H. Bates (Berkeley and Los Angeles: University of California Press, 1988).

policy: the abandonment of import substituting industrialization, the move toward export led growth, the stabilization of the macro-economy, privatization, the liberalization of markets, and so forth.⁶⁵ Others have taken the form of basic shifts in the structure of governance. Indeed, in close concert with the economic reforms of the 1980s has come the wave of political reforms of the 1990s, as authoritarian regimes have given way to regimes based upon democratic institutions.⁶⁶

The two kinds of reforms are often studied in isolation: the one by economists, the other by political scientists. But they should not be addressed separately. For the economic crisis of the 1980s was not just, or even predominantly, a crisis in private markets; it was also, and indeed preponderantly, a crisis of the state.⁶⁷ States ran out of revenues. They could no longer finance themselves, pay their bureaucrats, or afford the programs necessary to stay in power. In an effort to regain fiscal health, they therefore changed their policies. Many altered their political structures as well.

We often fail to recognize the state-centered nature of the crisis of the 1980s. In responding to it, international financial institutions promoted structural adjustment. The private sector had already adjusted by the 1980s, however. In goods markets, it had moved into illicit trade; in currency markets, into the black market; and in financial markets, it had fled abroad. The adjustment advocated by the international financial institutions advocated adjustment, then, were adjustments by the state. The crisis of the 1980s was a crisis of the

⁶⁵ See, for example, Haggard and Kaufman, The Politics of Economic Adjustment and Bates and Kreuger, Political and Economic Interactions.

⁶⁶ See Samuel Huntington, The Third Wave (Norman, Oklahoma: University of Oklahoma Press, 1991); Adam Przeworski, Democracy and the Market (Cambridge: Cambridge University Press, 1991); and Jeffrey Frieden, Debt, Development, and Democracy (Princeton: Princeton University Press, 1991). For a skeptical treatment, see John F. Helliwell, "Empirical Linkages Between Democracy and Economic Growth," British Journal of Political Science 24 (1994)225-248.

⁶⁷ As argued in Bates and Kreuger, Political and Economic Interactions and also by Bresser Pereira in Luiz Carlos Bresser Pereira, José María Maravall, and Adam Przeworski, Economic Reforms in New Democracies (Cambridge: Cambridge University Press, 1993).

public sector. And in demanding the reform of regulatory bodies, property rights, fiscal systems, bureaucratic practices, and so forth, the institutions that reconstructed international capital markets were promoting the restructuring of domestic political institutions as well.

The recreation of the international capital market in the 1980s, then, not only included the building of international organizations: the highly imperfect, politically managed consortia of finances for developing nations. It also led to the reform of domestic political institutions. These were not strengthened at the expense of the market, but rather in the service of the market, and, in particular, the market for capital.

It is notable, of course, that when domestic political institutions were revived in the 1990s, many took democratic form. Rather than serving as a principal, the executive branch reconfigured itself as an agent. Many governments assumed parliamentary form, with wealth holders gaining greater control over taxation and expenditure decisions. The executives it should be noted, did not give away power to weaken the state, but rather to gain access to the resources that would revive its ability to act. They shed sovereignty so as to gain power by gaining access to public revenues.

Underlying the arguments of many is a belief that the private market grow at the expense of the state. The strengthening of the one, they assume, implies the retrenchment of the other. But, as we have argued in this essay, to gain the benefits that capital markets can bring, individuals need to forge effective political institutions. The creation of political institutions is thus a corollary of the desire to invest.

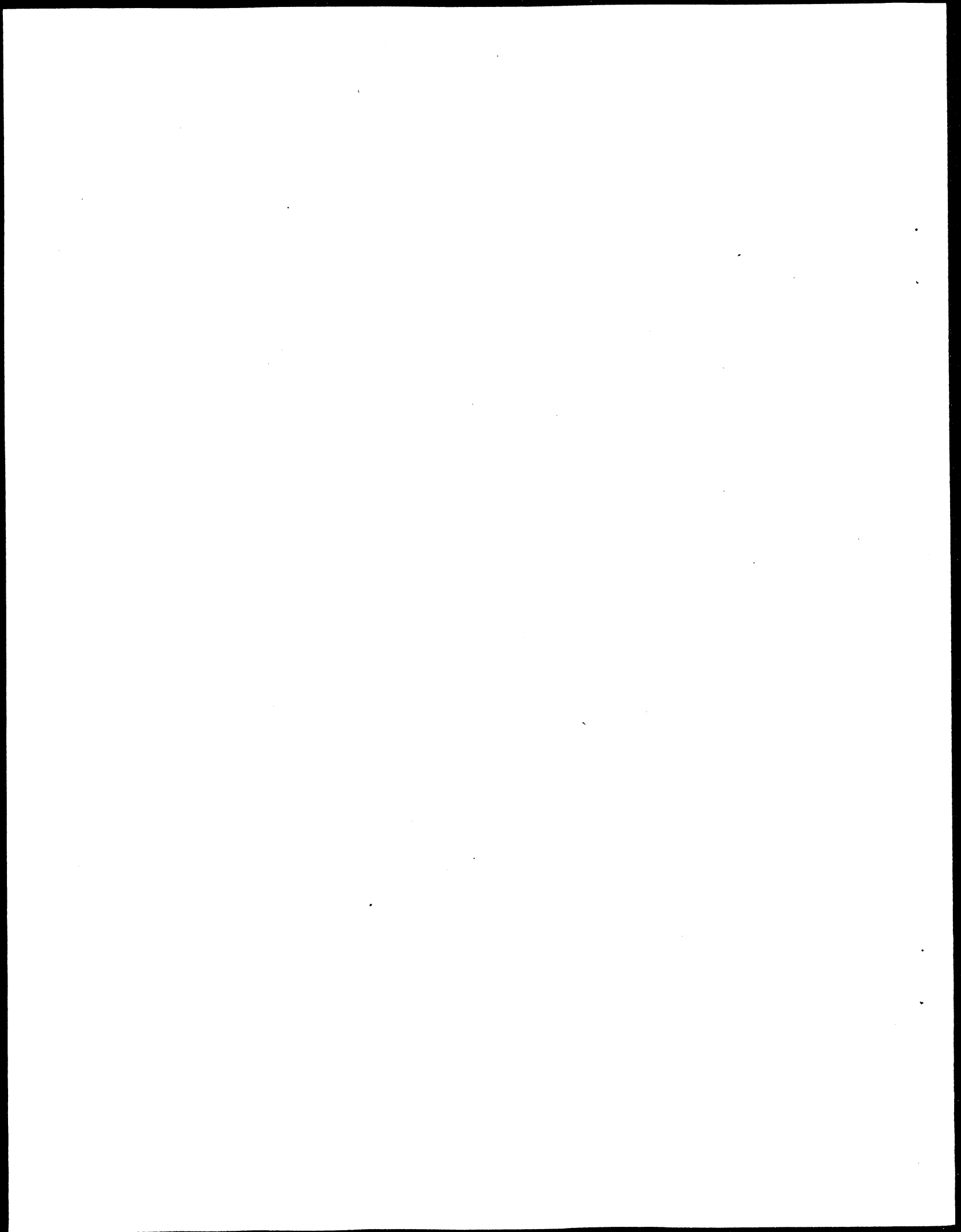
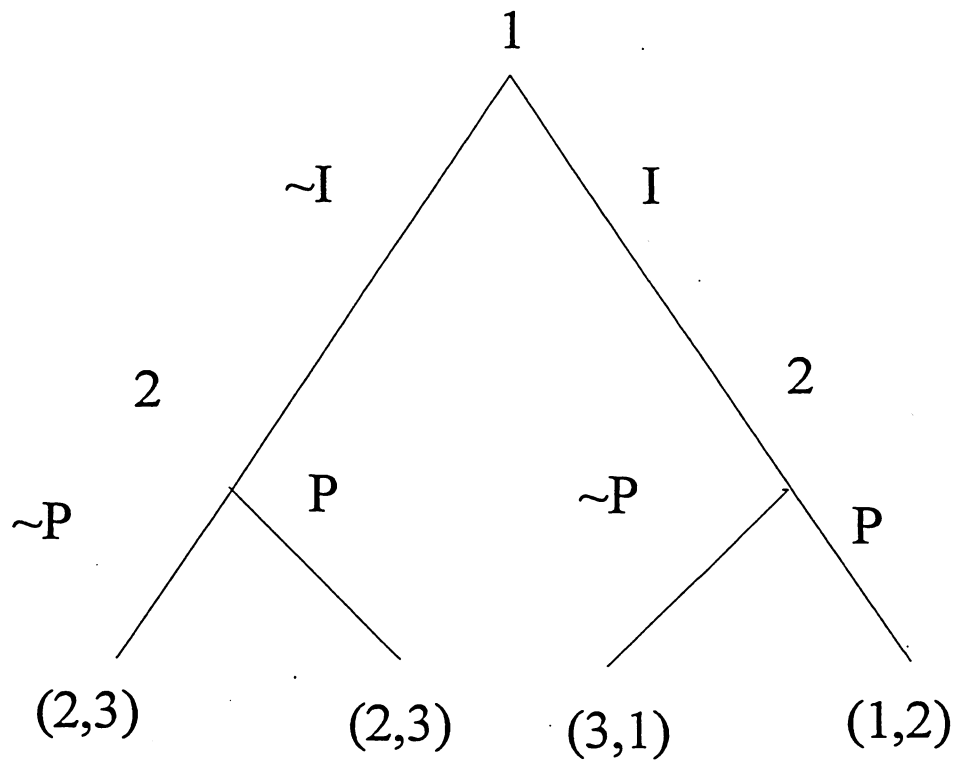


Figure 1
The Time
Consistency Problem



Players: 1,2

Actions: I : invest; $\sim I$: not invest
 P : perform; $\sim p$: not perform

Payoffs : 1 is high; 3 is low

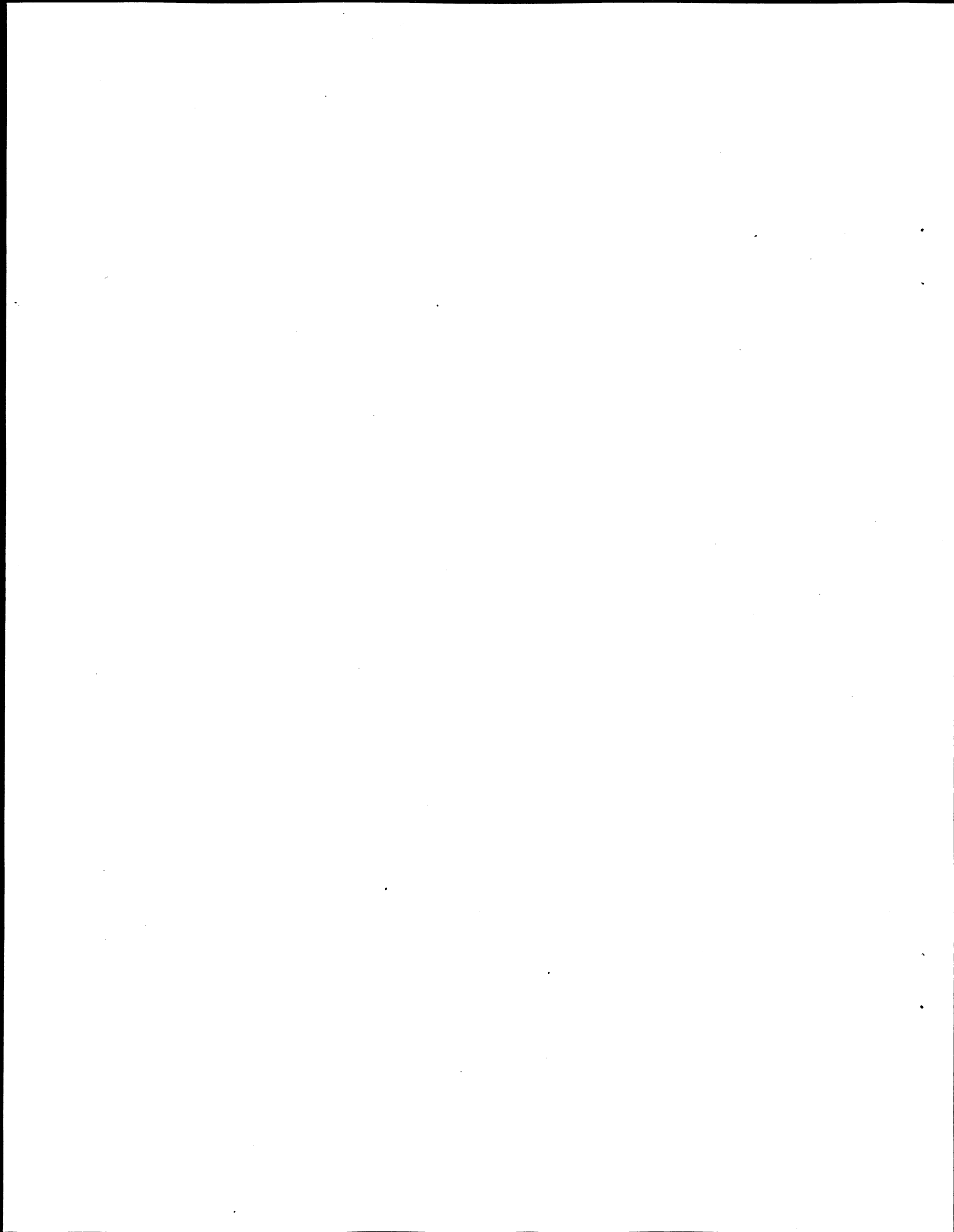
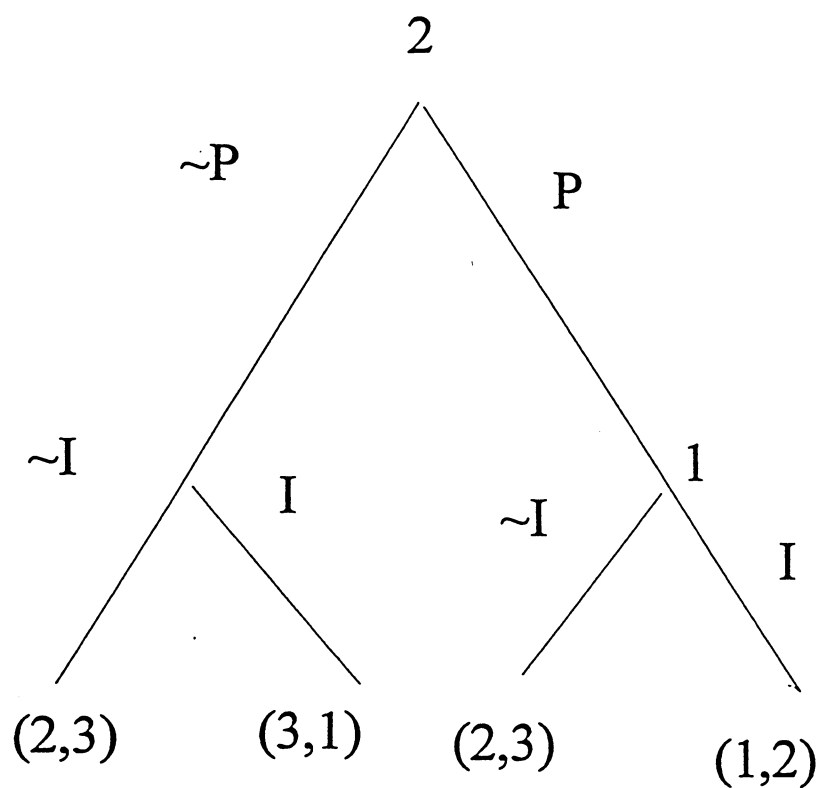


Figure 2
A solution



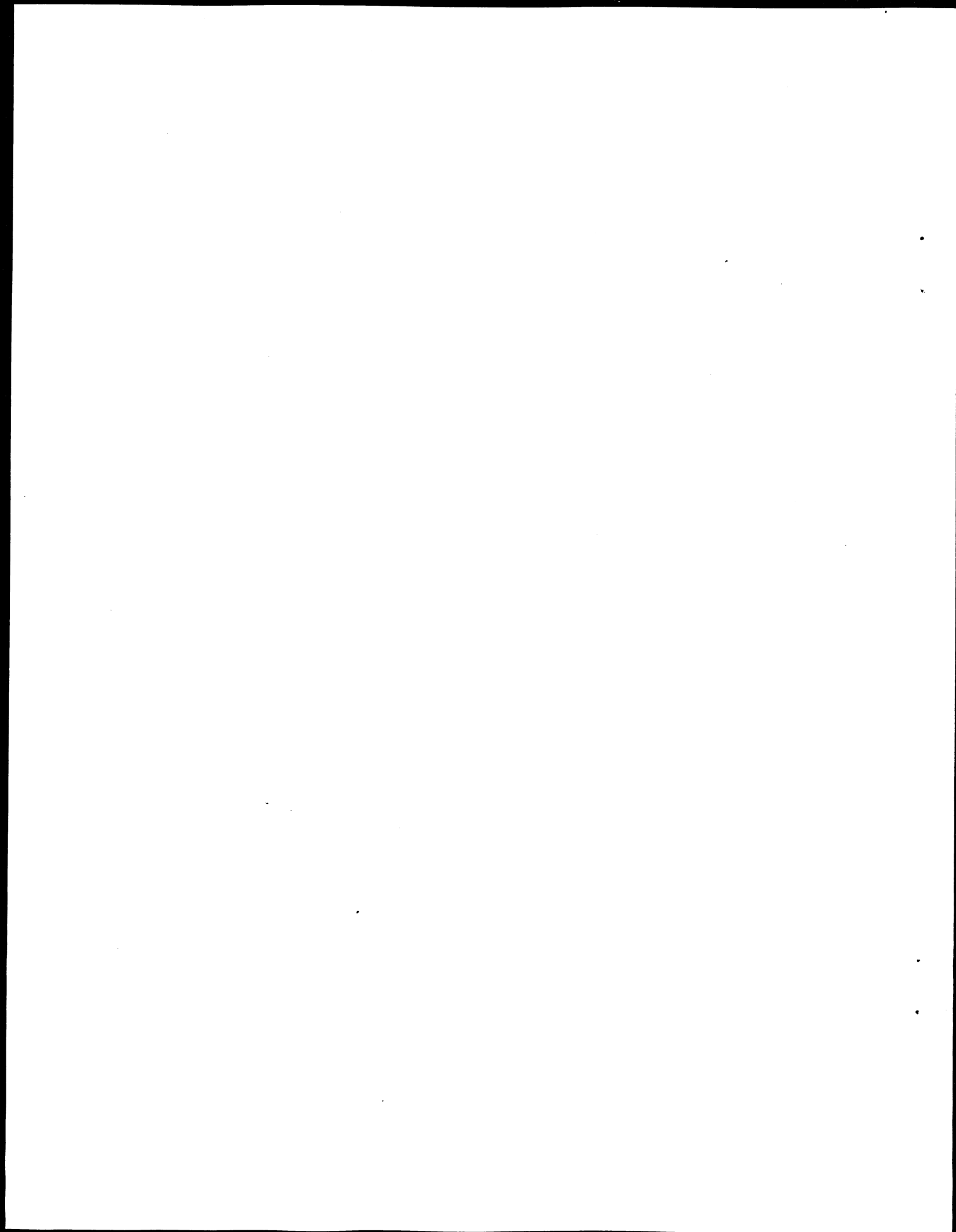
Players: 1,2

Actions I: invest; $\sim I$: not invest

P: perform; $\sim P$: not perform

Payoffs: 1 is high; 3 is low.

Player 1's payoffs are still listed first.



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