

Governance, Growth, and Development Decision-making

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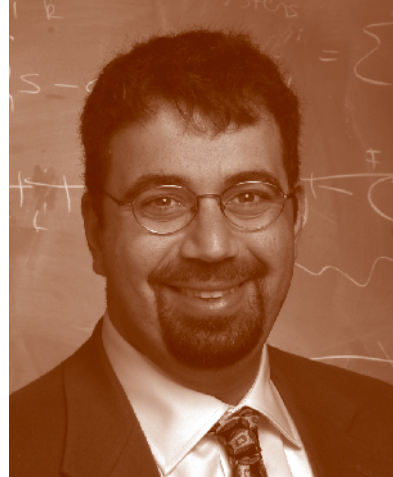
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Interactions between Governance and Growth: What World Bank Economists Need to Know

Daron Acemoglu



There is now a growing understanding that economic, political, legal, and social ‘institutions’ are essential to the economic success and failure of nations. Governance can be defined in various different ways, and its meaning certainly differs when we talk of corporate governance versus governance in general. In the context of economic growth and development, governance refers to essential parts of the broad cluster of institutions. Particularly important elements of governance, defined as such, would include the *political institutions* of a society (the process of collective decision-making and the checks on politicians, and on politically and economically powerful interest groups), *state capacity* (the capability of the state to provide public goods in diverse parts of the country), and *regulation of economic institutions* (how the state intervenes in encouraging or discouraging economic activity by various different actors). Thus the interactions between governance and growth are intimately linked to the interactions between institutions (broadly construed) and economic growth.

In the academic world, the understanding on the importance of institutions has been reached as a result of a large body of theoretical and empirical work. In the policy world, it has been reached more painfully, as a result of a long stream of reforms around the world that failed mainly because they did not pay attention to institutions and governance issues. We now know better. And yet, what we know is only the tip of the iceberg. As academics, we can hope that we will be able to learn more in the years to come. Policymakers do not have this luxury, and must give policy advice on the basis of what we currently know.

It is also not necessary (and in fact often not even productive) for international organizations in general, and the World Bank in particular, to look at the most current research to decide their day-to-day business. Academic research progresses slowly and according to its own dynamics, which often reward ideas that are contrarian even if they have little empirical relevance. Only ideas that have withstood the test of time will one day become relevant for the policy sphere. Having said that, there is now a sufficient body of work and a broad enough consensus on the importance of institutions and governance that it might be useful to contemplate what the lessons of this body of academic work are for the World Bank.

So what have we learned with the research of the past decade or so that can be useful to policymakers? My answer to this question can be summarized in six points.

1. Institutions Matter

The institutions of a country may create incentives for investment and technology adoption, for its businesses to invest, and the opportunity to accumulate human capital for its workers, thus engendering economic growth. Or they may discourage such activities, leading to stagnation. They may create incentives for politicians to work towards creating a growth-enhancing environment. Or they may encourage rent seeking activities, corruption, and the unfettered pursuance of personal gain at great cost for the rest of the society.

While there is relatively strong evidence showing that the *broad cluster of institutions*—comprising economic, political, and legal aspects—are essential for long-run economic development, we must be modest and admit that we are still at the beginning of the process of understanding how exactly specific aspects of institutions influence economic outcomes. For example, we can be fairly confident that today South Korea is much richer than North Korea because of its divergent (and more growth-enhancing) institutional path. But we do not know whether this is mostly because of South Korea's economic institutions that protect property rights, because

of its better educational institutions, because of its greater state capacity enabling the provision of the basic public goods, because of its greater financial development, or because of the political institutions that South Korea developed gradually after separation.

2. There Is No General Recipe for Improving Institutions

Exporting good economic institutions is as hopeless as exporting democracy. Institutional reform is essential for many societies to unleash their growth potential and it can happen as exemplified by successful cases of institutional reforms ranging from South Korea to Botswana. But such reform must have internal driving forces and what types of reforms can be successful will vary from country to country.

Importantly, the experience of both South Korea and Botswana highlights two important features of successful reform that we should bear in mind. First, *history is not destiny*. Countries can, and do, change in major ways and such change is what gives us hope that economic development will be more widespread during this century than the past one. In fact, a distinguishing feature of the understanding that institutions matter is also the recognition that institutions, as the collective choices of the society as a whole, can be changed to improve the living conditions in a country. We do not have the recipe for successful institutional change. But the idea that institutions can change should be an important part of our approach to less-developed economies and should give us hope about the future. Second, reform and the subsequent development of institutions must often rely on internal dynamics. In South Korea and Botswana, and in other cases, the path of institutional improvements would not have been possible without the participation and support of their population. Although there are cases, such as Germany and Japan after World War II, where external intervention played an important role in the subsequent development of institutions, these are exceptions rather than the rule. Our best hope for institutional improve-

ments lies with internal dynamics and we should strive to understand what generates positive internal dynamics rather than offering recipes for general institutional improvements.

3. Beware of the Pitfalls of Policy Reform and Recognize the Political Economy Constraints

While general institutional reform is beyond the reach of international intervention, World Bank economists, like other international policy actors, can and do encourage policy reform in various spheres. Such policy reform is an important part of the mandate of the World Bank. And yet, it is important to recognize that policy reform comes with *major pitfalls*.

To understand these pitfalls, note that policy reform is necessary, in general, not because country governments do not understand basic economic principles. Few politicians, for example, ever thought that hyperinflation would be good for economic growth. Hyperinflation often results from institutional equilibria, where politicians have incorrect incentives and must rely on deficits and inflation to buy support or to enrich themselves. These policies thus have their roots in the *political economy problems* of the society. These problems include weak constraints on politicians that make it possible for them to pursue policies to enrich themselves, political environments where it is possible or even necessary for politicians to use clientelistic policies and pander to the powerful constituencies in order to remain in power, and political institutions that fail to provide incentives to politicians to invest in public goods for the majority of the population. These political economy problems will not be solved overnight. Any policy reform must come to grips with these problems and the perverse incentives that they create. Implementing central bank independence in Africa or in other institutionally weak societies will be often unsuccessful because the political economy factors leading to distortionary policies in the first place are still present.

Policy reform that does not heed the political economy context might also lead to a distinctive seesaw pattern, with new policy dis-

tortions emerging to undo those that are being dealt with. If a political party is forced to give cheap credit to politically powerful groups in order to buy support and remain in power, imposing central bank independence will often induce the use of other means to buy the same support. The seesaw effect does not mean that policy reform is impossible or always useless. But it implies that policy reform, without understanding why policies were distorted in the first place and what the political economy constraints are, is likely to fail or may even create further inefficiencies. The first step in any process of policy reform must therefore be a sound understanding of what the causes of the implementation of the distortionary policies were in the first place.

4. Refrain from Policies that Will Create New, and Potentially Dangerous, Political Constituencies

Every policy intervention creates winners and losers. The winners not only gain economically, but also become politically powerful. These politically powerful groups can then become a barrier against further progress. This is well illustrated by the experience of import substitution, which supported nascent industrial groups in many developing economies. In most cases, the subsidized conglomerates were highly inefficient and became a formidable obstacle to further reform.

International organizations are still involved in various different types of programs that amount to picking winners. This is to some extent unavoidable, because every choice of project to be supported or subsidized will create some winners. Yet, it is important that these distributional implications of international programs are recognized and are managed appropriately.

There is also the danger that international organizations, including the World Bank, may become even more involved in selective subsidies and industrial policies in the years to come in response to the perceived failure of the Washington consensus. This is not the right place to debate whether or not the Washington Consensus

has failed. It suffices to say here that if the Washington Consensus has failed, it has certainly not done so because prescriptions such as reducing inflation and budget deficits and enforcing property rights were bad ideas; if it has failed, this is much more likely to have been because it did not pay attention to the political economy constraints inherent in policymaking.

The more important point is that there is a real danger that the next decade or so might witness a resurgence of various forms of industrial policies under one disguise or another. Industrial policy will only make the political economy problems facing developing countries worse. The job of the World Bank must be to discourage such policies. Industrial policy is not only often based on bad economics, but much more importantly, it is based on *bad politics*.

5. Growth Is Hard, or Impossible, without Public Goods

The emphasis on reducing the size of the government and limiting various different forms of government intervention that often lead to distorted incentives in the marketplace and to corruption is right. Nevertheless, the focus on these problems should not blind us to another important set of barriers to economic growth in poor economies: lack of infrastructure, roads, sanitation, basic educational institutions, and law and order for the citizens. In almost all of the poor and stagnant economies the government is not only corrupt and in the business of favoring special groups at the expense of the society at large, but it also fails in the provision of the most basic public goods to the large majority of its population. Modern economic growth requires a broad base and the mobilization of such a broad base is impossible without the relatively widespread provision of some of the most basic public goods.

The World Bank is often involved in programs that invest in public goods. Not all such programs are cost-effective and some may lead to waste. But we should still not lose sight of the general importance of public good provision and how the absence of the most

basic amenities often acts as an important constraint on economic development.

6. Advocate Openness and Transparency

While international organizations cannot export general institutional reforms, they can advocate openness and transparency in the policymaking process. Most instances of corruption are made possible by the secretive way in which policies are made in many developing economies. Openness and transparency in government procurement, subsidies, interventions and fiscal policies can reveal information to the public, with the potential of generating internal dynamics in favor of successful political economy reforms. This does not mean that openness and transparency are policies that should be imposed on all countries, regardless of conditions. Certainly, when dealing with a failed state or with a country at the brink of civil war, there are more important concerns than ensuring openness and transparency. Nevertheless, the long-run health of the political system often requires internal checks and balances, and openness and transparency are the best way of ensuring that such checks develop.

Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History

Douglass North

John Wallis

Barry Weingast



1. Introduction

Proponents of modern development advice face a paradox: why do so many developing countries fail to choose policies that economists argue are Pareto improving? Something is fundamentally wrong with this advice.

In a new book, we seek to address the above question by taking a broad view of recorded human history. The human world has undergone two dramatic social revolutions, both producing fundamental changes in the stock of knowledge. The first began 10,000 years ago: the discovery of agriculture, the growth of larger societies and the first cities, and the emergence of hierarchical social organizations. The second social revolution began about two hundred and fifty years ago: the discovery of new industrial technologies, the rise of nation states, and the emergence of new and sophisticated political and economic organizations. The two revolutions led to new ways of organizing human interaction and ordering societies. Our conceptual framework lays out the logic underlying the two new social orders and the process by which societies make the transition from one social order to another.

We term the first new social order that appeared ten millennia ago the *natural state*. Natural states use the political system to regulate economic competition and create economic rents; they then use those rents to order social relations, control violence, and establish

social cooperation. The natural state transformed human history; indeed, the first natural states developed techniques of building and recording that resulted in the beginnings of *recorded* human history. Most of the world today still lives in natural states.

Next, we consider the logic of the second new social order that emerged in a few societies at the end of the 18th, and beginning of the 19th, centuries—the *open access society*. As with the appearance of natural states, open access societies transformed human history in a fundamental way. Perhaps 25 countries and 15 percent of the world's population live in open access societies; the other 175 countries and 85 percent live in natural states. Open access societies regulate economic competition in a way that dissipates rents and uses competition to order social relations. Finally, we seek to explain how societies make the transition from natural states to open access societies.

2. The Conceptual Framework

In the primitive social order, human interaction occurs mainly through face-to-face repeated interaction; all relationships are personal. The typical size unit of human interaction is the band of about twenty-five people. The level of violence within, and between, groups is very high.

The natural state provides a solution to violence by embedding powerful members of society in a coalition of military, political, religious, and economic elites. Elites all possess privileged access to valuable resources or valuable activities and the ability to form organizations sanctioned by the larger society. Limiting access to activities, organizations, and privileges produces rents for elites. Because these rents are reduced if violence breaks out, rent-creation enables elites to credibly commit to each other to limit violence. Moreover, because peace depends on the balance of interests within the dominant coalition, limited access orders are sensitive to changes that alter elite interests. As a result, natural states are stable but not static. In comparison with primitive orders, limited access

orders significantly expand the size of societies. Hierarchies of elites build personal relationships that extend the control of the dominant coalition. Personal relationships in natural states result from traditional face-to-face interaction. In well-developed natural states, elite privileges include control over powerful social organizations, such as the church, governments, courts, and military units.

The open access order builds on the organizational achievements of the natural state but extends citizenship to an ever-growing proportion of the population. All citizens are able to form economic, political, religious, or social organizations to pursue any number of functions. The only proscribed function is the use of violence. Unlike the natural state, which actively manipulates the interests of elites and non-elites to ensure social order, the open access order allows individuals to pursue their own interests through organizations. Individuals continue to be motivated by economic rents in both political and economic markets, but the presence of open entry induces competition that tends to make such rents temporary. Social order is maintained through the interaction of competition, institutions, and beliefs. Control of the military is concentrated in government, and control over the government is subject both to political competition and institutional constraints. Attempts to use the government to coerce citizens, either directly through the use of military force, or indirectly through the manipulation of economic interests (e.g., rent-creation), result in the activation of existing organizations or creation of new organizations to mobilize economic and social resources to bid for control of the political system. Maintaining open access is critical to sustaining the social order.

Where limited access orders face constant adjustment to their political and social arrangements to accommodate changes in the interests of elites, open access orders face constant adjustment to their political and social arrangements to accommodate the rise of new political and economic interests and the creative destruction of old interests. Both social orders are stable as social orders, but not static in terms of short- and long-term fluctuations in economic and

political arrangements. In terms of economic outcomes, however, the open access order has proven much more successful at sustaining positive rates of growth over long periods in comparison to the more erratic stop and go character of economies in limited access societies. Similarly, the political framework has been more stable in the sense of fewer coups and other forms of disorder. The greater stability of open access orders does not stem from greater rigidity in social arrangements but from the opposite, from more fluid social arrangements that allow that order to respond more flexibly to changing conditions.

How is the transition made from one social order to another? Our book outlines the transition to open access orders in Britain, France, and the United States.

While the transition in each society depended on specific features of that society, there are common features to the transition. As a consequence, while the first transitions do not offer easily applicable modules or lessons for promoting development in today's natural states, they do provide critical clues to today's development problems. The doorstep conditions make it possible for elites to deal with each other impersonally, to reduce the incidence of disruptive violence, and ultimately to create and sustain impersonal elite rights. In each case, elites faced incentives to transform privileges into impersonal rights. The creation of a few elite rights under the doorstep conditions opens an opportunity to extend elite rights in a way that can be credibly sustained by the entire elite.

The privilege of owning shares in a joint-stock company may begin as a unique privilege. But if that privilege becomes widespread and shares are transferable—for example, because elites realize these changes will increase the value of their shares—then an elite interest in supporting impersonal exchange of shares can exist. Impersonal exchange in shares, in turn, may create an interest in impersonal formation of companies, forces that clearly came to the fore in all three countries in the late 18th and early 19th centuries. Open access to corporate forms becomes credible when large numbers of elite benefit directly. In a similar way open access to political organizations

can be sustained when powerful groups in the polity find it in their interests to support political parties.

The transition is about institutionalizing open access via impersonal relationships, not about adopting specific institutional forms, such as a bill of rights or the universal franchise. Institutions matter because they structure the incentives and constraints facing individuals. But as we have demonstrated, the same institutional forms work differently in different circumstances, particularly in the absence or presence of open access. Elections and corporations, for example, work differently in natural states than the same institutions work in open access orders.

This way of thinking about the transition process results in a new interpretation of the economic and political history of the birth of modern open access societies at the end of the 18th and the beginning of the 19th century. Our economic history emphasizes the concern about the development of powerful new forms of elite economic organizations and the ‘corrupting’ effect of these organizations on politics that led to the acceptance of open access in the mid-19th century. Our political history emphasizes modifications to natural state institutions in the 18th century that led to concern within the elite that political competition would inevitably lead to consolidated political control by a faction who maintained control through manipulation of the economy. Ultimately, elites moved to protect their rights through institutions that guaranteed open economic and political competition by allowing the formation of economic and political organizations at will, something the world had never seen before. The transforming effects of open access in the mid-19th century are manifest in the political and economic developments of the late 19th century and 20th century, including fostering more favorable circumstances for technological progress.

The historical details and specific institutional mechanisms that developed in each specific society were critically important in that society, but neither the specific details nor the specific institutions were the same across societies. The transition was secured in the middle of the 19th century by institutionalizing open access—by

adopting some set of institutions that guaranteed the ability to form political, economic, and social organizations at will for a substantial share of the population. Those citizens enjoyed impersonally defined rights and were embedded in a set of social arrangements that sustained impersonal relationships. The operation of existing natural state institutions, even institutions with long histories such as the British Parliament, began changing as access opened. Elected assemblies produced different outcomes in the presence of competitive political parties. Economic corporations produced different outcomes in the presence of competitive entry.

The adoption of similar institutions in other societies later in the 19th century did not immediately foster the transition in those societies. For example, Latin American countries that adopted constitutions similar to the United States constitution in the nineteenth century or the adoption of general incorporation laws elsewhere in Europe were not sufficient in themselves to induce the fundamental transformation. Elite interests in limited access societies can easily be served by elections, representative assemblies, and more sophisticated corporate and other organizational forms. But adopting the institutional forms of Britain, France, or the United States without securing open political and economic access is insufficient to produce the transition. History shows that adopting better institutions enables the adopting societies to function better as natural states.

3. Economic and Political Development

Our approach provides a new perspective on problems of economic and political development. Development is not a matter of adding more capital or grafting the right institutions onto a society, such as democracy, property rights, markets, or the rule of law. Nor does it simply involve providing the right mix of public goods, such as social insurance or education.

Our approach enables us to see that the institutions, rights, and policies central to the open access order's success directly threaten the stability of the natural state. Without first producing the transi-

tion, transplanting these institutions and policies cannot produce economic development in natural states. Economists typically conclude that natural states suffer from too much market intervention: control of markets, laws fostering monopolies and other rent-creating privileges, inadequate property rights, ineffective public goods provision, and incomplete markets. All this is true. The economists' natural prescription is to suggest that a country 'reform;' that they systematically adopt policies that mimic those in open access orders: less regulatory control, absence of monopolies, more secure property rights, improved public goods provision such as education, and more complete markets. Such an approach ignores the fact that natural states adopt limited access policies not just to maximize the incomes of the ruling elite, but because limited access policies address the problem of violence by giving individuals and groups with access to violence an incentive to cooperate. Policies from open access orders—universal, impersonal rights and rule of law—reduce the natural state's ability to control violence. These changes threaten to make people worse off, not better off. Modern economics fails to understand this because it assumes the problem away, implicitly making the Weberian assumption that the state has a monopoly on violence and does not use it to exploit citizens.

An implication of the above is that the dynamics of social change for developing countries lies in the logic of the natural state, not in the logic of the transition. With few exceptions, most developing countries today do not meet the doorstep conditions. They are not in a position where elites can credibly deal with others through impersonal relationships in critical matters of economic and political interactions. Transitions to well-defined elite rights are not sustainable under such conditions. The transfer of institutions from open access orders to natural states cannot, in and of itself, produce political and economic development. Indeed, to the extent that institutional forms are forced onto societies by international or domestic pressure but do not conform to existing beliefs about economic, political, social, and cultural systems, the new institutional forms are likely to work less well than the ones they replace.

If standard development advice is wrong, what should developing countries do? How do they get on the path of transition from natural state to open access order? There is no easy answer to this question, no magic bullet.¹ The important insight of our framework is that development advice should take account of the logic of the natural states. In particular, it should focus on where an individual natural state is on the progression of natural states; that is, whether it is fragile, basic, or mature, or on the doorstep. Advice should focus on helping fragile natural states become basic ones; basic ones, mature; mature ones to the doorstep; and, finally, natural states on the doorstep to enter the transition proper. Similarly, advice should focus on institutions and organizations that help reduce the threat of violence and disorder.

¹ Nonetheless, we make several suggestions, as we spell out in a bit more detail in our work with Stephen Webb; North, Douglass C., John Joseph Wallis, Steven B. Webb, Barry R. Weingast (2007). *Limited Access Orders in the Developing World: A New Approach to the Problems of Development*, Policy Research Working Paper 4359, The World Bank, September

Thinking about Governance

Dani Rodrik



A deep insight that has emerged out of the disappointments of the Washington Consensus is that successful *policy* reform is at its core *governance* reform. Reforms in the areas of, say, trade or fiscal policy require much more than just cuts in tariffs and a balancing of the budget. If you want to achieve lasting change and have a real impact on the behavior of those agents that determine the success of reform, you must change the “rules of the game”—the manner in which trade policy is made or fiscal policy is conducted. This insight, assisted and reinforced by the academic literature on institutions and growth, has in turn produced a new development agenda focused on a broad list of governance reforms. These reforms target a lengthy list of objectives, including reducing corruption, improving the rule of law, increasing the accountability and effectiveness of public institutions, and enhancing access and voice of the citizenry. The agenda is neatly captured and quantified by the Kaufmann-Kraay Governance Indicators data set.

Much of this is for the good. In particular, the tilt towards governance has the virtue that it helps shift the focus of reforms towards objectives that are desirable end-goals in and of themselves. The items on the original Washington Consensus agenda were all of instrumental value at best. Playing around with tariff and tax schedules and with the composition of public expenditure is worthwhile only to the extent that it achieves other objectives we really care about: increased growth, reduced poverty, improved equity. By contrast, it would be hard to take issue with the intrinsic importance of improved governance along its various dimensions: rule of law, transparency, voice, accountability, effective government. We might even say good governance is development itself. Combine it with *material* well-being, and we attain the Nirvana of advanced societies.

So, good governance is both an end and a means. It is a key goal of development, broadly construed, and it is also an instrument for achieving better policymaking and improved economic outcomes. Any sensible discussion of governance must be clear about the distinction. And it must clarify in which of these two senses governance is “the problem” we are trying to fix.

I make the following points below. First, economists have very little useful to contribute to governance-as-an-end. Second, while they have more to say about governance-as-a-means, what they do say is often not what they should say. Where economists can be useful is in designing institutional arrangements for specific policy reforms targeted at relaxing binding growth constraints—what one might call “governance in the small.” This agenda differs quite a bit from the broad governance agenda on which much ink is being spilt. And third, there are sometimes tradeoffs between governance-as-an-end and governance-as-a-means which policymakers and advisors need to be conscious of.

1. Governance as an End

The hallmark of an “advanced” developed society is a government that exhibits the attributes of good governance—transparency, effectiveness, rule of law, lack of corruption, voice and participation. From Adam Smith on down, economists have recognized the importance of these attributes. But they have had much less to say about how to achieve them—and for good reason. These are at their core social, political, and legal arrangements which markets—and economic analysis—typically presuppose. They are deeply embedded in the history, traditions, and politics of a society. As such they are the province of legal scholars and political scientists, rather than economists. The latter have the tools that can provide analytical and occasionally prescriptive clarity to the issues, and these can be immensely helpful once the discussion moves a couple of notches down in terms of specificity—as I will argue further below. But economists have neither absolute nor comparative advantage in

thinking about how to build the rule of law in a society, enhance its voice and accountability, or control corruption at large.

So my bottom line for economists in the business of offering advice on governance-as-an-end would be simple: don't do it!

2. Governance as a Means

Governance has instrumental value insofar as it provides producers and households with greater clarity on the rules of the game and investors with greater assurance that they can appropriate the returns to their efforts. That is the essential point that the institutions-and-growth literature has emphasized. It is also the main rationale for thinking of governance reform in the context of growth strategies.

The long-run association between good governance and high incomes is incontrovertible. The existence of a *causal* link from the former to the latter is now also widely accepted. What is less well understood is that this long-run association provides very little guidance for appropriate strategies to induce high growth. It certainly does not suggest we can systematically rely upon *improved* governance to generate *increased* growth over the time horizons that policy makers and their advisors care about (a decade or two). I am not aware of any strong econometric evidence that relates standard governance criteria to *growth* (all the evidence is about *income levels*). And there are enough countries that are growing rapidly despite poor governance—China, Vietnam, Cambodia to name some of the prominent Asian examples—to render suspect any general claim to the contrary. Indeed, we should take it as good news that large-scale institutional transformation—of the type entailed by the governance agenda—is hardly ever a prerequisite for getting growth going.

This may seem paradoxical at first sight, but it should not be. Poor countries suffer from a multitude of constraints, and effective growth policies are those that address the most binding among them. Poor governance *in general* may be the binding constraint in Zimbabwe and some others, but it apparently was not in China, Vietnam, or Cambodia, and it most surely is not in Ethiopia, South

Africa, El Salvador, Mexico or Brazil. As a rule, broad governance reform is neither necessary nor sufficient for growth. It is not necessary because what really does the trick in practice is removing successive binding constraints—whether they are supply incentives in agriculture, infrastructure bottlenecks, or high cost of credit. It is not sufficient because sustaining the fruits of governance reform without accompanying growth is quite difficult. Consequently, a broad governance agenda rarely deserves priority as part of a growth strategy—except for in those rare instances where weak governance is specifically identified as a *generic area* of binding constraints.

3. Governance Reform in the Service of Growth

Broad governance reform may not deserve priority in a growth program in general, but this does not mean that a growth strategy should not also have a governance component to it. However, this component will be specific to the identified constraint and will entail those institutional arrangements that are best tailored to relaxing the relevant constraint in a sustainable manner.

To illustrate the point, imagine that we identify macroeconomic instability as the binding constraint in a particular economy. In a previous era, an economist-advisor may have recommended specific fiscal and monetary policies—a reduction in fiscal expenditures, a ceiling on credit—geared at restoring macroeconomic balances. Today, she may well supplement these with recommendations that are much more institutional in nature and fundamentally about governance. So she may advocate making the central bank independent—so that political meddling becomes less likely in the future—and also changing the system that governs fiscal policy; setting up fiscal rules, for example, or allowing the legislature only an up-or-down vote over budget proposals. The idea behind these proposals is that you need to change the underlying institutional arrangements if you want to change the equilibrium to which policy outcomes gravitate.

I gave the example of macroeconomic policy because this is an area where economists have done a lot of thinking about the insti-

tutional prerequisites and one where they have been remarkably effective. A similar kind of institutionally-rich thinking has developed in a few other areas as well—as in education policy and in telecom regulation. But in many other areas, such thinking is either quite naïve or non-existent. I would cite trade policy and industrial policy as examples of the first and second categories, respectively. In trade policy, the long-standing advocacy by external advisors of uniform tariff rules (or of external commitments) is typically motivated by very poorly articulated political and institutional priors—basically lots of arm-waving. And in industrial policy, the dominant view—held essentially on a priori grounds—seems to be that the requisite institutional arrangements are impossible to design and implement, even when such a policy is desirable in principle.

As the example of central banking shows, economists have a lot to contribute to thinking about such issues in specific policy areas. Their understanding of the substantive issues, their professional obsession with incentives, and their eye for the unanticipated consequences give them a natural advantage in designing institutional arrangements to further the objectives in question while minimizing behavioral distortions. A certain amount of local knowledge is clearly indispensable here. Economists need to understand the local context well enough to recognize the limits on the range of possibilities and to anticipate the likely obstacles. But doing this in the context of relaxing a constraint in a particular policy area—be it monetary policy, trade policy, industrial policy, or education policy—seems to be an order of magnitude simpler than designing wholesale legal reform or mounting an effective anti-corruption drive across the board. And as I have argued above, it is also more effective where growth is concerned.

4. Avoiding the Best-practices Trap

Designing appropriate institutional arrangements requires local knowledge *and* creativity. What works in one setting is unlikely to work in another. In a second-best, (i.e., real) world, the nature of

the binding constraint and their interactions with other distortions will influence the desirable arrangements. Import liberalization is fine as a way of integrating with the world economy when import-competing interests are not powerful and the currency is unlikely to get overvalued, but export subsidies or special economic zones will work far better in those other circumstances. Central bank independence may be a great idea when monetary instability is the binding constraint, but it will backfire where lack of competitiveness is the real challenge. Entrepreneurship is best stimulated by removing impediments to entry or by subsidizing the incumbents, depending on whether the binding constraint is lack of competition or lack of Schumpeterian rents.

Unfortunately, the type of institutional reform promoted by multilateral organizations such as the World Bank, IMF, or the World Trade Organization is biased instead towards a best-practice model. It presumes it is possible to determine a unique set of appropriate institutional arrangements *ex ante* and views convergence towards those arrangements as inherently desirable. One of the apparent virtues of this approach is that it enables cross-national comparisons and benchmarking: institutional performance can be measured by, say, counting the number of days it takes to register a firm in different countries or settle a commercial dispute in courts. This mode of thought is grounded in a first-best mindset which presumes the primary role of institutional arrangements is to minimize transaction costs in the immediately relevant domain—without paying attention to the nature of the binding constraint or the potential interactions with institutional features elsewhere in the system.

The broader point that these considerations highlight is that there is no unique, non-context-specific way of achieving desirable institutional outcomes. Effective institutional outcomes do not map into unique institutional designs. Institutional function does not determine institutional form. And because there is no unique mapping from function to form, it is futile to look for uncontingent empirical regularities that link specific institutional rules to economic outcomes. What works will depend on local constraints and opportu-

nities. Best-practice institutions are, by definition, non-contextual and do not take account these complications. Insofar as they narrow rather than expand the menu of institutional choices available to reformers, they serve the cause of governance badly.

5. Tradeoffs

One benefit of making the distinction between governance-as-an-end and governance-as-a-means is that it enables us to recognize tradeoffs that may have otherwise escaped our attention. Consider again some illustrations.

Suppose your growth economist identifies a poorly functioning legal system and the attendant uncertainty as one of the binding constraints on growth. One solution of the “governance-in-the-small” type is to “outsource” part of the country legal system to the outside world. The government can accomplish this, for example, by signing on to bilateral investment treaties (BITs) with major trading partners. These typically have arbitration clauses that enable foreign investors to seek redress under foreign jurisdictions in a variety of circumstances. One can presume that such clauses increase the comfort factor for foreign investors and that they may therefore help overcome the identified growth constraint. But is this strategy also good for governance-as-an-end? Probably not. Aside from creating an unhealthy distinction between domestic and foreign investors—the latter have the extra protection but the former don’t—such outsourcing of legal powers does nothing to strengthen domestic legal institutions. Insofar as it removes an important source of pressure for legal reform, the outsourcing may even delay the establishment of a healthy judiciary.

A similar tension arises with many other forms of external or internal commitments aimed at enhancing the domestic investment environment: fiscal rules, central bank independence, tariff bindings at the WTO, regional trade agreements, IMF or World Bank conditionality. These are least problematic when they have their roots in the government’s desire to constrain its future behavior in view of

standard time-inconsistency problems. But equally often, the motive is to constrain not one's own future behavior, but that of the rival political group or of the opposition in case they assume power. Effective as this may be as growth policy in the short run, the broader governance implications of such commitments are worrisome.

Or consider the establishment of foreign trade zones where firms are allowed to operate under different fiscal regimes and less burdensome labor laws. Once again, these may be effective as growth policies, but they raise important questions where governance standards are concerned.

There are no obvious and clear-cut solutions when such trade-offs arise. The best that one can hope is that policy advisors and their principals make their choices while being fully cognizant of them.

6. Concluding Remarks

Good governance is good in and of itself. And it can also be good for growth, when it is appropriately targeted at the binding constraint. For most countries the "good governance" and the "governance for growth" agendas are likely to differ substantially. Economists have precious little to say about how to achieve the first of these, but plenty to contribute to the second. From a growth standpoint, the risk is that the governance agenda takes an independent life of its own, and that it becomes divorced from the particular governance challenges that are most closely linked to stimulating and sustaining economic growth.

What Do We Know About the Relationship between the Political and Economic Dimensions of Development?

Francis Fukuyama



1. Overview and Definitions

This note outlines what we know about the relationship between the economic and political dimensions of development, and draws some implications of this for development strategies.

I define economic development simply as increases in per capita gross domestic product (GDP) over time.

Political development is more complex, and involves at least three separate components. The first is state-building, which involves creating a legitimate monopoly of coercive power; defining the state's territorial extent; and creating administrative capacity in the form of public bureaucracies that can enforce rules, extract taxes, and provide basic public goods. The second component is rule of law, in which the state's discretion is limited by clear and transparent formal rules. Rule of law is the basis for property rights and the adjudication of commercial claims, and protects a private sphere and individual human rights. Finally, democracy is the exercise of popular sovereignty through regular multiparty elections. Consolidated democracies employ other mechanisms for holding governments accountable to the people besides elections, such as separated powers by which different parts of the state monitor each other's behavior, and a free press and civil society outside of the formal political system that can monitor and check the government's performance.

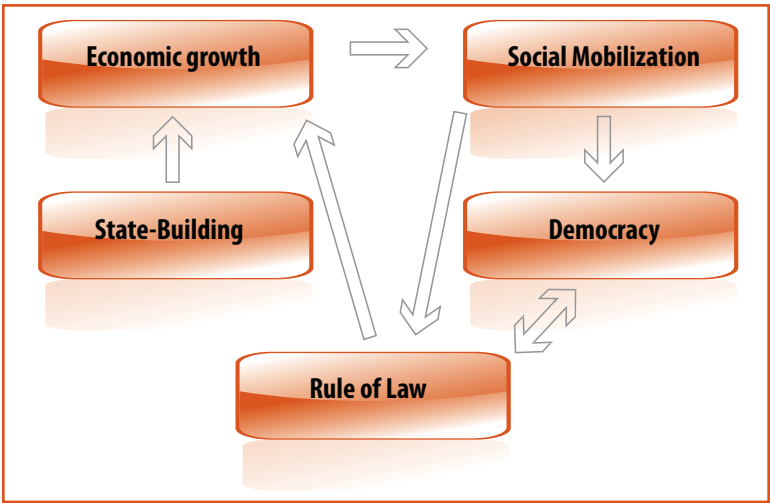
In addition to economic and political development, there is a separate sphere of social development. The latter consists of the

emergence of a complex division of labor, and a shift in social identities from ascriptive ones, based on class, ethnicity, or gender, to ones that are voluntary. While social development as an end in itself is not the subject of the current note, it is an important intermediary variable between economic and political development.

We thus end up with five separate dimensions of development, one economic, three political, and one social. All five are goals of development in themselves, and they can exist, for the most part, independently of one another.¹

Figure 1 summarizes the presumed relationships between these five dimensions of development that will be fleshed out below.

Figure 1



¹ That is, one can have growth without democracy, and social development without increases in either state capacity or democracy. It is possible to have an illiberal democracy, and a liberal autocracy, and both democracies and autocracies can experience either low or high growth. While a rudimentary state is a necessary precondition for economic growth, rule of law, and democracy, it is also possible to have some or all of the latter three conditions in a weak state.

2. Causal Relationships

There is a large econometric literature linking institutions to growth,² which I will not deal with in any depth here, except to note that “institutions” (as well as the related term “governance”) as an independent variable is often used inconsistently, referring at different times to state capacity, rule of law, and democracy. Each of these three components of political development has different effects on growth.

For example, state capacity would seem to be much more important than either rule of law or democracy, particularly at low levels of per capita GDP (i.e., below \$1000). Neither South Korea during the 1960s or 70s, nor China from the period 1978-present, had a strong rule of law; property rights were partial and insecure, and there was a weak legal infrastructure in both countries. They did, however, possess strong developmental states that maintained political order and pursued pro-developmental rather than predatory policies. Their growth rates were not worse than territories like Hong Kong or Singapore that inherited modern rule-of-law systems from the British.

There is a growing literature showing how property rights do not have to be universal to sustain impressive levels of economic growth,

² For example: Acemoglu, Daron, Robinson, James A. et. al., (2001). “The Colonial Origins of Comparative Development: An Empirical Investigation,” *American Economic Review* 91(5): 1369–401

—Knack, Steve, and Phil Keefer. “Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures.” *Economics and Politics* 7 (1995): 207–27

—Rodrik, Dani, Arvind Subramanian, and Francesco Trebbi. “Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development.” *Journal of Economic Growth* Vol. 9, No. 2, June 2004

—Kaufmann, Daniel, and Aart Kraay. “Growth without Governance,” in *Economía*, Winter 2002. <http://www.worldbank.org/wbi/governance/pubs/growthgov.html>

at least for limited periods.³ That is, elites can grant property rights to themselves, or else create complex rules allocating rents, in ways that still support growth. There are, however, important political consequences of partial property rights regimes that have feedback effects on growth through the social or political channels (see below).

Property rights are more important to growth than individual human rights (e.g., freedom of speech, association, religion) or political rights. We know of many fast-growing regimes that offer full, partial, or quasi-property rights without protecting other types of individual rights (China, Malaysia, Singapore, the United Arab Emirates).

The relationship between political accountability (a.k.a. democracy) and growth is quite complex. In the aggregate, the relationship between growth and democracy has been generally seen to be significantly weaker than the reverse relationship between democracy and development.⁴ There is also a great deal of confusion as to how to measure the degree of democratic accountability, since democracy itself is a multidimensional collection of inter-related institutions.⁵

³ For example: Haber, Stephen, Armando Razo, et. al. (2003). *The Politics of Property Rights* (Cambridge: Cambridge University Press); Khan, Mushtaq H. and Kwame Sundaram Jomo, eds., (2000). *Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia* (Cambridge: Cambridge University Press)

⁴ See, *inter alia*: Lipset, Seymour Martin, (1959). "Some Social Requisites of Democracy: Economic Development and Political Legitimacy," *American Political Science Review* 53: 69–105

—Diamond, Larry, (1992). "Economic Development and Democracy Reconsidered," *American Behavioral Scientist* 15(4–5): 450–499

—Barro, Robert J., 1997. *Determinants of Economic Growth: A Cross-Country Survey* (Cambridge: MIT Press)

Przeworski, Adam, Alvarez, Michael et. al., (1996). "What Makes Democracies Endure?" *Journal of Democracy* 7(1): 39–55

⁵ 'Democracy' is sometimes used interchangeably with "liberal democracy" (i.e., including rule of law, which does not always accompany democratic institutions). Democracy is also sometimes identified with checks on executive authority (see Acemoglu and Robinson 2007; Kaufmann and Kraay 2005). However, a British-style Westminster system has very few formal checks on executive power when compared to an American-style presidential system (see Fukuyama 2007); yet both types of democracy have been able to sustain high long-term growth rates.

The actual impact of democratic institutions on growth is, in fact, highly contextual. In countries ruled by competent developmental states, greater political participation, particularly if introduced suddenly, may lead to increased demands for redistribution and rent-seeking, both of which may be detrimental to growth. On the other hand, in countries with some combination of predatory states, low capacity, and high levels of corruption, democratic accountability may be the only route available to institutional change and long-term growth.

3. Endogeneity and Feedback Loops

I take for granted the fact that a certain basic level of state capacity is the sine qua non of any degree of economic growth. Collier (2007)⁶ demonstrates the converse of this, that absence of a state and the existence of conflict is bad for growth). Beyond this, however, there is a large debate over the endogeneity of institutions, and the degree to which the political and social consequences of growth have feedback impacts on growth.

Jeffrey Sachs has been a lonely voice arguing that institutions are almost entirely endogenous to growth.⁷ He is undoubtedly right that institutions are to some extent endogenous; very poor countries lack human and material resources to staff bureaucracies and provide a range of public goods. But his failure to recognize the

⁶ Collier, Paul, (2007). *The Bottom Billion: Why the Poorest Countries are Failing and What Can Be Done About It* (Oxford: Oxford University Press)

⁷ See: Sachs, Jeffrey and John W. McArthur (2001). *Institutions and Geography: Comment on Acemoglu, Johnson, and Robinson* (2000) (Cambridge, MA: NBER Working Paper 8114); Sachs, Jeffrey and Andrew Warner (1995). *Natural Resource Abundance and Economic Growth* (: NBER Working Paper 5398).

importance of institutions as independent or intermediate variables supporting growth has been well documented.⁸

Economic growth does, however, have certain predictable social and political consequences that affect the conditions for institutional change and hence growth in subsequent time periods. For example, a lot of classic social theory predicates the emergence of modern civil society on economic development.⁹ As growth occurs and firms take advantage of economies of scale, social specialization increases and new social groups (e.g., an industrial working class) emerge. The fluidity and open access demanded by modern market economies undermines many traditional forms of authority and encourages the replacement of ascriptive with voluntary social groups.

The emergence of new social actors as a result of development has a complex and potentially opposite impact on state-building, rule of law, and democracy, and consequently on prospects for growth. On the one hand, Huntington (1968)¹⁰ argued that there is often a negative relationship between the mobilization of new social actors and political order when existing political institutions could not accommodate their demands for participation. Something like this scenario is unfolding today in Andean countries like Ecuador and Bolivia, where newly mobilized indigenous communities are demanding greater political participation in destabilizing ways.

On the other hand, there is another body of thought that argues that growth produces a propertied middle class, which then presses for a rule of law to protect those rights, and subsequently political participation. The correlation that exists between economic

⁸ If resources alone were enough to guarantee good institutions, it is hard to explain the divergent development paths of South Korea and Nigeria since the 1950s.

See, for example: William Easterly & Ross Levine, (2002). "Tropics, Germs, and Crops: How Endowments Influence Economic Development," NBER Working Papers 9106, National Bureau of Economic Research, Inc, revised.

⁹ For example: Gellner, Ernest, (1994). *Conditions of Liberty: Civil Society and Its Rivals* (London: Hamish Hamilton)

¹⁰ Huntington, Samuel P., (1968). *Political Order in Changing Societies* (New Haven: Yale University Press).

growth and stable liberal democracy¹¹ is presumably mediated by this channel: growth entails the emergence of new social actors who then demand representation in a more open political system. If the political system succeeds in incorporating these actors, this is positive for both political stability and long-term growth, as in the case of contemporary Korea.

The distribution of growth can also have a critical impact on social stability. Many observers have pointed to the importance of land reform in Japan, South Korea, and Taiwan prior to their high-growth periods, and subsequent investments in human capital, which further helped to ensure that growth would be evenly distributed. Latin America, by contrast, has been characterized over the past two centuries by high degrees of social inequality, by which elites have protected their own property rights and underinvested in human capital. Despite the existence of formal democratic institutions, inequality has been transmitted over the generations. As recent research has shown, partial property rights regimes can be successful at underpinning growth for sometimes prolonged periods, but they can then be interrupted by zero-sum conflicts over redistribution that account for the region's long-term lagging performance.

4. Development Strategies

The fact that there are at least five separate economic, political, and social dimensions of development suggests that any one of them could be an entry point for a development strategy. One important school would prioritize some combination of economic development, state-building, and rule of law over democracy or social mobilization. Huntington (1968) and Zakaria (2003),¹² noting that

¹¹ Lipset, Seymour Martin, (1959). "Some Social Requisites of Democracy: Economic Development and Political Legitimacy," *American Political Science Review* 53: 69–105

¹² Huntington, Samuel P., (1968). *Political Order in Changing Societies* (New Haven: Yale University Press)

Zakaria, Fareed, (2003). *The Future of Freedom: Illiberal Democracy at Home and Abroad* (New York: W. W. Norton)

there is a much stronger correlation between state capacity and rule of law and economic growth than there is between democracy and growth, have argued in favor of liberal autocracy over illiberal democracy as a platform for economic growth. This is of course the strategy followed by developmental states like South Korea and Taiwan.

The authoritarian transition has been strongly criticized, however, as a general development strategy, most recently by Thomas Carothers (2007).¹³ It depends on the existence of competent states with significant capacity to manage economic policy. Such liberal autocracies are a category of countries that is virtually non-existent outside of East Asia. Many authoritarian rulers are not interested in rule of law, are corrupt and do not pursue good development policies, and indeed preside over states that are predatory rather than developmental. In other cases, authoritarian leaders who do pursue pro-development policies early on (like Uganda's Museveni or Ethiopia's Zenawi) don't stick with them over time; the absence of democracy means there is no check on their power.

For the large class of developing countries that cannot use economic growth and state-building as entry-points for a broader development strategy like the East Asian fast developers different entry points are necessary.

For certain middle-income countries like Brazil, Colombia, and Peru, increasing the quality of democracy is a potential entry-point to strengthening rule of law and, down the road, improving economic performance. The rising quantity and quality of democratic participation in all three countries over the past 30 years, coupled with constitutional changes devolving greater power to municipalities and local governments, have had the effect of increasing the accountability of many politicians to their electorates.¹⁴

¹³ Carothers, Thomas, (2007). "The "Sequencing" Fallacy," *Journal of Democracy* 18(1): 12–27.

¹⁴ In Brazil, for example, voters in state elections have started to punish old-style patronage politicians at the polls, and have rewarded those providing genuine public goods.

According to Huntington, social mobilization may be an important entry point for development in the case of “blocked” countries. A case in point is Ukraine. In the period after 2001, Ukraine suffered from economic decline, high levels of corruption, lack of transparency, and what seemed to be an unaccountable political system. As a result of the Orange Revolution in December 2004, the political system has become much more competitive and accountable, though the country continues to suffer from corruption and lack of transparency. Ukraine’s economic performance after 2005 has been stronger than Russia’s, which was moving in the opposite direction with regard to accountability.

Finally, there may be a set of cases where economic growth, not underpinned by a strong developmental state, but by a state with “just enough governance,” (Levy and Fukuyama 2007)¹⁵ may become a platform for development in the political and social dimensions. The current governance orthodoxy at the World Bank and other donor agencies is that since good institutions cause growth, institutional reform should always be an entry point for development. But Hausmann, Pritchett, and Rodrik (2004)¹⁶ suggest that growth accelerations can and have occurred under a wide variety of institutional and policy regimes, something borne out by the experience of the period 2003–2007 when virtually every country and every region in the world experienced relatively good growth. Fixing the problem of corruption and democratic accountability in a country like Bangladesh is a daunting task at present. On the other hand, it has had just enough governance to continue to grow impressively; to the extent that good governance is endogenous to growth it may be better positioned to reform its institutions in a decade or so when it reaches a significantly higher level of per capita GDP.

¹⁵ Levy, Brian and Francis Fukuyama, (2008), “Development Strategies: Integrating Governance and Growth”, Washington, DC: mimeo, January

¹⁶ Hausmann, Ricardo, Lant Pritchett and Dani Rodrik (2004). “Growth Accelerations” National Bureau of Economic Research Working Paper Number 10566

6. Conclusions

The discussion above offers a broad view of the diverse strategic choices available to development decision-makers, and helps clarify how the preferred choice might be conditioned by a country's unique historical circumstances. It highlights a variety of distinctive dynamic sequences, which differ from one another both in their points of entry and, more broadly, in what comes before what as development unfolds. The relevance of each of these distinct sequences depends on country-specific realities. To be sure, the discussion has painted with a very broad brush. But the risk of taking an excessively broad view seems less worrying than the alternative that seems all too common in the current discourses on both governance and growth: partial approaches; cookie-cutter recommendations that fail to account for countries' radically disparate circumstances; and inattention to dynamic processes that link the different dimensions of development.

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