Governance Institutions and Economic Performance

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What is economic governance?

- Fashionable buzzword:
  - EconLit cites: 1970-79: 4, 1980-89: 98, 1990-99: 6178, 2000-07: 15455
  - Google pages: 152,000
- A definition: legal and institutional framework to support economic activity and economic transactions by protecting property rights, enforcing contracts, and taking collective action to provide physical and organizational infrastructure.

Importance of governance 1

- Security of property rights:
  - Provide incentives to save and invest
  - Achieve efficient allocation of assets
  - Enable productive use of labor
- Enforcement of contracts:
  - Fear of counterparty cheating may prevent mutually gainful transactions

Importance of governance 2

- Collective action: Provision of public goods, management of common pool resources
  - Resolution of numerous prisoners’ dilemmas – avoid free riding, prevent overuse of resources
  - Taken via governments, NGOs, communities
  - Informal social institutions (networks, norms, sanctions) need collective action
  - Collective action to constrain governments

Economic versus corporate governance 1

- Transactions between different entities vs. internal incentives within a firm.
- Interrelated because boundary of firm determined by transaction (including governance) costs.
- If economic governance is low-quality, firms will be larger, with internal transactions, implicit contracts, corporate governance.

Economic versus corporate governance 2

- Examples: family-owned conglomerates in India, Turkey etc. These function as an internal capital market.
- This compartmentalization is inefficient – good investment opportunities outside the family firm cannot be taken because external contracts are unreliable.
- Need to improve governance institutions for better capital allocation in the economy, better economic performance.

Governance is not always supplied by *the government*

- Governments are important, especially to protect property rights; their failure (e.g. corruption) is a major cause of poor economic performance in many countries, especially LDCs and transition economies.
- But other social institutions exist, especially in niches that the government serves poorly or not at all. Sometimes they work better than the formal law, because they have better expertise or information. They are essential for guarding against the government's own misbehavior.

Private economic *transactions* occur outside *markets*

- Classical markets – anonymous traders, goods of perfectly known quality, instantaneous payment.
- Reality – [1] Many transactions between identified parties: Within families, friends, firms, members of business associations. [2] Quality of goods not immediately known, payment deferred, sometimes unspecified future favor.
  - Don Corleone’s gift to Bonasera.

Formal law is not the same as effective order

- Distinguish *de jure* and *de facto* law
- Even in solving pure coordination problems, there can be:
- Law without order
  - http://www.youtube.com/watch?v=H2JFL1Sk21Y
- Order without law
  - http://www.youtube.com/watch?v=5WU8hilbN9Y
  - http://www.youtube.com/watch?v=eC4BN9kInXg

Government itself may violate rights and contracts

- Governments and their agents violate rights:
  - Expropriate assets without compensation
  - Impose higher taxes, change regulations
  - Demand bribes for licenses etc.
- Uncertainty, arbitrary policies can be worse than stable high tax rates. Countries can reach middle-income levels despite some corruption, but further growth requires much better institutions. (Easterly 2001, pp. 234-5, 245-8,   Rodrik 2003 pp. 16-17)

Most economies have mixed forms of governance

- Arbitration and other ADR forums work with formal law in the background.
- "in a free society governed by the rights and responsibilities of its citizens, the vast majority of transactions … presuppose trust in the word of … strangers. … Reputation and the trust it fosters [are] the core attributes of market capitalism."

  - Alan Greenspan, The Age of Turbulence, p. 256

Social institutions like trust also have their limits

- "The most effective defense against fraud … is counterparties' surveillance. JPMorgan thoroughly scrutinizes the balance sheet of Merrill Lynch before it lends. It does not look to the SEC to verify Merrill's solvency." – Greenspan, *Age of Turbulence,* p. 257.
- "Doveryai, no proveryai. Trust, but verify."

  - Ronald Regan
- Example: e-bay's rating system worked well when its scale of operation was small, but now has to be backed up by some formal monitoring and enforcement mechanisms.

Issue is not the old-style "market versus government"

- Governmental and private institutions of governance coexist even in modern market economies, and many economic transactions take place outside conventional markets, e.g. within families, social networks, and firms.
- Object of study is interaction of the whole system of governance and transactions – what combinations work better under what conditions.
- General principle – nothing is perfect; everything is "second-best" at best.

Types of governance institutions

- Formal, governmental
  - Constitution, legislation, police, courts, licensing and regulatory agencies, ...
- Informal, private
  - Social networks for search and information
  - Norms of behavior, and sanctions for enforcement against violations of norms
  - Private adjudication and enforcement (non-profit or for-profit)

Private protection of property rights

- Deterrence:
  - Private guards, gated communities
- Punishment:
  - mafias (Sicilian studies by Bandiera, Gambetta; others elsewhere)
  - Create negative externality on unprotected assets, so protectors can charge high fees (Bandiera)

Guarding against the government's predation

- Guilds in medieval Europe solved collective action problem of sanctioning rulers who violated members' rights (Greif, 2006, ch.4)
- Modern business associations can play similar roles, and develop "anti-corruption norm":
  - Commit to resisting demands for bribes, and sanction members who pay bribes
  - Ensure media exposure, and resist attempts to control or censor media

Corruption: Organized and disorganized

- Many licenses and separate officials $\Rightarrow$ excessive and uncertain bribery (Shleifer and Vishny, 1998, ch. 5, Easterly 2001 pp. 247-8)
- Better to have one agency, "internalize externality" among bribe-seekers
  - "One-stop" licensing agencies (but must combine central, state, local)
- One license but competing authorities $\Rightarrow$ bribes competed down to zero
  - Two or more one-stop agencies?

Contracts – trust and credibility

- Classic example:
  - "If a Covenant be made, wherein neither of the parties performe presently, but trust one another; … upon any reasonable suspition, it is Voyd: … For he that performeth first, has no assurance that the other will performe after; because the bonds of words are too weak to bridle mens … avarice. – Thomas Hobbes, Leviathan, 1651, Ch. 14.
  - Recent work: Williamson, Greif

Contracts – prisoner's dilemmas

- Arise in all economic transactions except purely spot exchanges of commodities of perfectly known quality.
- Typical "relational" solution: Repeated play with enough profit every period to make one-time cheating unattractive.
- Other solutions:
  - Ex ante precautions: choose and inspect partners.
  - Ex post detection and immediate punishment

Types of private contract governance mechanisms

- First-party: working on the potential cheater's own internal value system.
- Second-party: detection of cheating and enforcement by counterparties in this or related transactions within a group.
- Third-party: detection and enforcement by someone with no direct participation in this set of transactions. Often done for profit.

First-party institutions

- Economists have neglected these methods, but they are very important in practice.
- Preference formation using religion, socialization etc.
  - Religion: “Thou shalt not steal” etc.
  - Socialization: family and schools teaching empathy, fairness, sharing, civic duties etc.
- Can be sustained by cultural group-selection for “strong reciprocator” strategies (Boyd, Gintis, Bowles & Richardson 2003)

Second-party institutions

- Here I include not only repeated interaction between a given pair, but also multilateral enforcement among a community of traders.
  - This sense of "second party" is different than that of Greif; he calls this "collectivist" (2006, Ch. 9).
- Examples:
  - Greif's Maghribi traders (2006, ch. 3)
  - Industry associations, Better Business Bureaus

Bilateral versus multilateral enforcement mechanisms

- Multilateral is harder, needs good information in long-run stable community:
  - Not just cheating or accident, but who cheated? If can't identify guilty, may need blunt punishments
  - Participation in punishment may be public good, needs "second-round enforcement"
- So try to build upon successful encounters for regular, ongoing pairwise relationships.
- But multilateral may be unavoidable:
  - "Always go to other people's funerals. Otherwise they won't come to yours." - Yogi Berra

Third-party institutions

- Governance by outsiders who are not direct parties to this class of transactions. This has subcategories:
  - Provision of information that then becomes an input to second-party enforcement
  - Private adjudication and enforcement under the shadow of formal law
  - Direct enforcement for profit by the third party
  - Enforcement by governmental or quasi-governmental bodies.

Private third-party contract governance institutions

- Examples
  - Information: credit-rating and quality certification agencies
  - Adjudication: private judges at medieval trade fairs (Milgrom-North-Weingast)
  - Enforcement: punishment of miscreants
- Info and Enfo function of the Sicilian mafia: "When the butcher comes to me to buy an animal, he knows that I want to cheat him [by supplying a low-quality animal]. But I know that he wants to cheat me [by reneging on payment]. Thus we need Peppe [the third party, mafioso] to make us agree. And we both pay Peppe a commission." Gambetta (1993, p.15)

Advantages and limits of private contract enforcement

- Industry experts can better evaluate information. Business and social communities can inflict severe punishments. Courts recognize these advantages. Will enforce arbitration decisions, not rehear case.
- Honesty of third parties not automatic; governance works by converting one-shot dilemma game of the first two parties into repeated game of each with the third party. Each needs enough share in the total surplus; this places upper and lower bounds on the fee of the third party (Dixit 2004 Ch. 4).
- Information, communication channels weaker when size and scope of system is large. Growth requires shift toward formal governance (Li, Dixit 2003 ch.3).

Non-governmental solutions of collective action problems

Ostrom, Ellickson, Libecap etc. find importance of

- Local information about
  - Consequences of misbehavior
  - History of individual members' behavior
  - Membership of group, their rights, duties
- Matching rules to information
- Devising correct incentives to adhere to norms, and to partake in imposing sanctions
- Graduated punishments (contrary to much of the theory of repeated games)

Evolution of institutions toward efficiency

- "Discriminating alignment hypothesis": transactions align with governance structures to minimize transaction costs (Williamson).
- This can work well and reasonably quickly when the decision is made by one actor, e.g. vertical integration choices by firms. Much harder when collective / political action needed; long delays and lock-in possible (North, Eggertson).

Transition and interaction problems

- New or reformed formal institutions can fail if they interact badly with existing informal.
  - Formal titling can fail in its aims if existing informal rights cannot be overridden (Ensminger).
  - Arm's length market arrangements can destroy existing relational arrangements that serve other aims such as insurance (Kranton & Swamy).
  - Method of transplanting law more important than type of legal system (Berkowitz et al.)
  - It may be necessary to accept some transitional worsening of performance (Dixit 2004 ch. 2).

Some findings from studies of institutional reform

- Government important partner, facilitator, but top-down reforms may be difficult and results may be disappointing (Easterly, Rodrik 2008)
- Social entrepreneur can take initiative; others are compelled to follow: CEO of AFLAC allows shareholder vote on his compensation.
- Media, public interest litigation, people's courts, can help (but can also hurt if they pursue special group interests too far).
- Crises conducive to change (Olson) Competition forces change (North)

Suggestions for policy advisers

- Before recommending change, think whether existing institutions and organizations are there for a good reason, and how your reforms would interact with them in the short run and the long run.
  - "Evolution is smarter than you are." - Richard Dawkins (quoted by Easterly 2008)
- Case studies and theory give some general principles; these must be combined with context-specific knowledge to get workable reforms.
- Recognize diversity of problems and correspondingly of solutions. Take suggestions from locals.

Suggestion for policy makers

- *The Economist* (April 26, 2008 Special Report) praises “a quintessentially Vietnamese trait: casting around for role models, then trying to meld the best aspects of several of them into something uniquely suited to Vietnam”.
- Listen to everyone – Washington consensus, UN agencies, academic experts, journalists and columnists, … Don’t slavishly follow any one, not even your own prior dogmatic belief. Study your situation in light of theories and other cases; then make your own choice.
  - Example – Amundsen v. Scott (Huntford)

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