Good Governance, Institutions and Economic Development: Beyond the Conventional Wisdom

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Abstract:
This paper offers a critical review of the fast-growing comparative research on institutions and economic performance, with emphasis on its analytical and policy implications. The article attempts to identify some of the conceptual gaps of the political economy of growth literature. By doing so, it also evaluates the key assumptions underpinning the increasingly dominant good-governance approach to development. Both analytical and policy issues are discussed in reference to the contrasting experiences of East Asia and Latin America. This paper claims that future scholarship on this field should be based on a more rigorous conceptual distinction between the rules of the game and the play of the game, and between the political and the institutional embedded in the concept of governance. It also stresses the importance of taking seriously the endogenous and distributional nature of institutions, and of moving beyond the narrow property-rights approach to governance and development. By providing some insights about the political channels through which institutions affect economic performance, this article seeks to contribute to the consolidation of a theory-driven, empirically-grounded and policy-relevant research programme on the political and institutional foundations of growth and prosperity.
“A recent surge of research on the effects of institutions and politics on economic growth has convincingly shown the importance of these elements of social structures...If I were to write this book five years from today, I probably would write the same book except for the chapter on institutions and politics, because I believe that much progress will be made in this area in the next few years.”

Elhanan Helpman (The Mystery of Economic Growth, 2004)

A growing literature stresses that governance, broadly defined as the traditions and institutions that determine how authority is exercised in a country (Kaufmann et al. 2000), matters to economic development. Building on the ideas of neo-institutional scholars such as Douglass North and Mancur Olson, several cross-national empirical studies have found a positive relationship between the quality of institutions and governance structures and economic growth.1 In this context, it is not surprising that a broad consensus among growth economists, development experts and international policy-makers has begun to view “good governance” as a pre-requisite to sustained increases in living standards (Kaufmann et al. 2000; Knack 2003).

Although this new comparative literature has made important advances in uncovering the political, institutional and social determinants of economic growth, the governance-matters approach to development is not without problems. Cross-national studies showing that good governance is a key determinant of economic performance can be challenged on the grounds of causality problems (Chong and Calderon 2000), measurement errors (Glaeser et al. 2004), missing-variable considerations (Bardhan 2005) and conceptual vagueness (Weiss 2000). Most decisively, the new political economy of growth still lacks a proper grasp of the channels through which institutions affect growth (Helpman 2004) and of the political sources of good institutions. As the Director of Global Governance and Regional Capacity of the World Bank Institute (WBI) recognises, “one of the most difficult issues in the field of governance is the imperfect understanding of how politics shapes governance and development outcomes” (Kaufmann 2003a: 27).

In the light of these remaining problems, it is legitimate to revisit the merits of the proposition that institutions do significantly matter for growth and, by implication, of the policy prescription that developing countries should invest in governance-enhancing reforms if they want to foster economic development. This article aims to provide a critical survey of the expanding comparative literature on good governance and economic performance, with emphasis on discussing its analytical and policy implications. At the analytical level, the objective is to identify some of the conceptual problems of this literature and discuss how research done in the areas of new institutionalism, analytical political science and international political economy may benefit future econometric works. At the policy level, the goal is to assess the merits of the good-governance approach to development in the light of two central concerns: the lack of understanding of the political sources of governance and development, and the endogenous nature of institutions. By seeking a more analytically informed and policy-relevant account of the relationship between governance, institutions and outcomes, this article intends to contribute to the consolidation of this fascinating, and open-ended, research programme on the political and institutional sources of growth and development.

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The rest of the paper is organised as follows. In Section 1, I review the ‘state of the art’ of the comparative literature on governance, institutions and economic performance. In Section 2, I point out some significant analytical gaps of the new econometric research on institutions and economic growth, with emphasis on lessons drawn from the works of North, Bardhan and other neo-institutionalist scholars. In Section 3, I assess the policy implications of the good-governance approach to development. In Section 4, I use the contrasting experiences of East Asia and Latin America to underline the major insights of this paper. In the concluding chapter, I outline the analytical, methodological and policy implications of this article, and provide some ideas for further research.

1. The State of the Art

“For all the effort put into growth theory and empirics in the last decade, there is still much that we do not understand, both in general and in relation to the political economy of growth”

Allan Drazen (Political Economy in Macroeconomics, 2000)

Research on the empirical determinants of economic growth has exploded in the last decades, as hundreds of cross-national studies have been undertaken to approach the elusive and ever-important question of what causes growth and the prosperity of nations. Economists have traditionally focused on the effects of physical and human capital accumulation, total factor productivity, technological innovation, the process of knowledge creation and diffusion, and international economic integration (Helpman 2004). However, experts have increasingly recognised that politics and institutions are key to the process of economic growth by affecting the incentives to accumulate, innovate and accommodate change. In this context, an active research programme has sought to model and test empirically the political determinants of growth. The purpose of this section is to discuss one of the most fertile areas of research within the political economy of growth, the one looking at the impact of property rights and institutions on economic performance.3

The first attempt to combine economic and political analyses to account for the determinants of economic growth studied the effect of political regimes on economic performance. Research looking at whether democracy promotes or hinders economic growth has produced three schools of thought (Feng 2003): the conflict school that argues that democracy hinders economic growth, mainly in less developed countries, by creating consumption pressures, fuelling distributitional conflicts and inhibiting capital accumulation; the compatibility school that contends that democracy enhances economic growth, because the existence of fundamental civil liberties and political rights generate the social conditions most conducive to economic development; and the sceptical school that claims that there is no systematic relationship between democracy and economic development. Typically, the advocates of the conflict school used the cases of some East Asian countries (notably South Korea and Taiwan) and Chile as evidence that “good-for-growth” dictatorships could create the right conditions for growth by providing the sources of political order and social control. However, this argument is refuted by Przeworski et al. (2000: 178), who having

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2 We cannot present here a comprehensive review of this huge and fast-growing literature. However, Barro and Sala-i-Martin (1995), Barro (1998), Drazen (2000) and Helpman (2004) provide excellent surveys of the work done in this field.

3 Drazen (2000) offers a thorough review of the new political economy of growth.
examined the experiences of 135 countries from 1950 to 1990, concluded that “there is no trade-off between democracy and development, not even in poor countries”.

Przeworski and his colleagues show, quite compellingly, that there is no evidence to support the claim that democracy needs to be sacrificed in the name of economic development. Yet, it is also true that the empirical evidence on the relationship between political regimes and economic growth is still ambiguous. In a comprehensive review of the literature, Feng (2003: 320-1, emphasis added) argues that: "despite fertile theoretical literature on the subject, cross-national quantitative efforts at testing various hypotheses fell short in their attempt to produce clear empirical evidence. Some empirical studies have found no significant relationship between economic growth and regime type, while others have established a strong impact of democracy on growth. Yet others have ascertained only a weak positive effect of freedom on growth, or even a negative influence of freedom on growth. Several regional studies focusing on developing countries have also produced ambiguous findings". Having realised that the type of political regime makes little difference in terms of observed growth rates (which by default seems to support the claims of the sceptical school), many political economists began to investigate the economic effects of institutions and governance structures.

The “institutional turn” in the political economy of growth gained momentum in the mid 1990s, especially with the publication of two pioneering articles: Stephen Knack and Philip Keefer’s Institutions and Economic Performance and Paolo Mauro’s Corruption and Growth. By relying on novel measures of institutions and property rights, these articles signalled the beginning of a new generation of research dedicated to testing the proposition that institutions do matter for economic performance in a cross-country setting. Unlike what has happened with the literature on political regimes and growth, the claim that institutions matter has received strong support. Building on data for up to 97 countries for the period 1974-89, Knack and Keefer (1995) finds that the quality of institutions, operationalised as the security of property rights and the level of contract enforcement, is crucial to growth and investment. In the same fashion, Mauro (1995) shows that subjective indexes of corruption are negatively linked with investment and economic growth. Further empirical tests supported these initial findings. For example, Alesina (1998) demonstrates that institutional quality, as measured by bureaucratic efficiency, absence of corruption, protection of property rights, and the rule of law, is important for growth.

Taken together, the above-mentioned articles represented a breakthrough in the business of modelling and measuring institutions in the context of cross-country growth regressions. As regards to their findings, this literature seemed to provide empirical support to the ideas of North and Olson, who stressed the role of secure property rights and effective contract enforcement in creating the political conditions for economic growth.

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4 On these ambiguous findings see the classic work of Sirowy and Inkeles (1991), and also Przeworski and Limongi (1993), Mantzavinos (2001) and Lane and Ersson (2003).
5 Other authors have chosen to look at the indirect effects of democracy on growth. See Feng (2003).
6 Earlier attempts to test the impact of civil and property rights on growth in cross-country regressions include Kormendi and Meguire (1985), Grier and Tullock (1989) and Scully (1988).
for growth and prosperity. Moreover, the existence of an institutions-to-growth link has appeared to address some of the anomalies of old and new growth theories, which were not able to explain the absence of general convergence or why the most rapid growth tends to occur in a subset of low-income countries (Olson 1996; Knack 2003). In the light of these new findings, the name of the game is conditional convergence based on institutions: relatively poor countries can enjoy rapid catch-up growth if they adopt good institutions.

There is no doubt that per capita income and the quality of governance are strongly positively correlated across countries (Kaufmann and Kraay 2003). Yet, reverse causality is always an issue in growth regressions. In this case, problems may arise not only because causality may run from income to institutions, but also because several institutional variables are measured at the end (or too close to the end) of the growth period. It is fair to recognise that the above-mentioned papers used several methods (including two-stage estimations in the case of Mauro) to minimise reverse causation problems (Knack 2003). However, Chong and Calderon (2000), applying a more rigorous approach to causality to the same data, found strong evidence of causation running in both directions: from institutions to growth and from growth to institutional quality. Building on a new dataset and using nonsample information, Kaufmann and Kraay (2003) find no evidence of a positive effect of incomes on the quality of institutions, calling into question the often-heard argument that good governance is a luxury that only wealthy countries can afford. In a more comprehensive challenge to the mainstream literature, Glaeser et al. (2004: 285) show that “the evidence that institutions cause economic growth, as opposed to growth improving institutions, is non-existent”.8

Omitted variable biases may also account for the correlation between good governance and high growth (Bardhan 2005). Many authors have examined, for example, the effect of geographical and historical factors in shaping both institutional and economic development. Sachs (2001) finds that geography, reflected in terms of weather conditions and access to sea-trade, plays a major role in countries’ economic success. On the other hand, Acemoglu et al. (2002) rejects this view and confirms the primacy of colonial institutions over geography.9 Their work shows that variations in local conditions faced by European colonizers “played an independent role in the emergence of institutions and in their impact on long-term development” (Helpman 2004: 125). Other studies have documented the importance of factor endowments (Engerman and Sokoloff (2000), ethnic conflicts and heterogeneity (Easterly and Levine 1997; Keefer and Knack 2002), legal tradition (La Porta et al. 1998; D矸jankov et al. 2003), colonial heritage (Hall and Jones 1999; North et al. 2000) and religious composition (La Porta et al. 1998).10 As Bardhan (2005) stresses, the institutional economics literature has critically overlooked the role of the state in resolving coordination failures and facilitating private-public sector cooperation in early stages

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8 They also show that the instrumental variable approach used by several authors is flawed and does not tell us what causes growth.
9 See also Rodrik et al. (2004) and Easterly and Levine (2002). On the geography versus institutions debate, see the thoughtful discussions provided by Helpman (2004) and Bardhan (2005).
10 On the validity of these findings, see again Helpman (2005) and Bardhan (2005).
of industrialization, not least in postwar East Asia.\textsuperscript{11} The all-important Olsonean problem of how interest-group formation intersects with institutions in affecting economic growth is also missing in most tests of the institutional sources of development (Helpman 2004).

The first generation of research on governance and growth was also undermined by the quality of the available data. Typically, the Gastil indexes of political freedom and civil liberties were used as proxies of countries’ institutional environment.\textsuperscript{12} Other researchers captured the security of property rights with objective indicators measuring the frequency of political violence.\textsuperscript{13} As both measurement strategies delivered questionable proxies of concepts such as the rule of law, contract enforceability or the security of property rights, researchers sought more direct and efficient measures of governance (Knack 2002). In this context, Mauro (1995) and Knack and Keefer (1995) revolutionised the art of measuring institutions by introducing the use of subjective indicators produced by private international investment risk services.\textsuperscript{14} These indexes provide information of significant institutional features such as corruption, governments’ repudiation of contracts and bureaucratic efficiency for a large sample of countries. However, perceptions-based ratings may be affected by expert’s knowledge of recent economic performance and better reflect conditions facing foreign investors.\textsuperscript{15} More recently, the WBI has taken a leading role in promoting a systematic approach for measuring institutions by developing a large set of aggregate indicators of governance.\textsuperscript{16} This development is expected to improve the quality and expand the scope of the works oriented to assess the determinants and consequences of good and bad governance (Kaufmann et al. 2000). Although this new dataset is suitable for mapping out governance profiles and gaps across countries, it is less useful (at least for the time being) for making causal inferences about the relationship between institutions and growth.\textsuperscript{17}

Glaeser et al. (2004) observe that most indicators of institutional quality used to establish the proposition that institutions cause growth are constructed to be conceptually unsuitable for that purpose. The heart of their critique points to the fact that these indicators are not measuring \textit{institutions as constraints} (which is the key claim of the theoretical literature on institutions), but are actually measuring institutional outcomes or performance. According to these authors, these governance indicators are too volatile to reflect more or less permanent features of the political environment and tend to rise with per capita income. By questioning the most common measures and instrumental techniques used in the empirical literature on institutions and growth, Glaeser and his collaborators challenge some of the basic

\textsuperscript{11} The role of the state in East Asia is analysed in Amsden (1989), Wade (1990), Evans (1995) and Cypher and Dietz (2004). For an attempt to test the impact of state structures on economic performance in a cross-country setting see the pioneering work of Rauch and Evans (2000).

\textsuperscript{12} See Kormendi and Meguire (1985), Scully (1988) and Grier and Tullock (1989).

\textsuperscript{13} See the works of Barro (1991), Londregan and Poole (1990) and Alesina et al. (1996).

\textsuperscript{14} In particular, these works used indexes taken from Business International (BI), the International Country Risk Guide (ICRG) and the Business Environmental Risk Intelligence (BERI).

\textsuperscript{15} Knack (2003) and Kaufmann et al. (2005) discuss the pros and cons of perceptions-based measures of governance.


\textsuperscript{17} The data only covers the period 1996-2004.
methodological foundations of the institutions-matters conventional wisdom.\textsuperscript{18} In my opinion, the article also raises interesting analytical questions regarding the conceptualisation of institutions, the uncritical use of institutions and governance as similar concepts and the nature of the theoretical link between governance, institutions and economic development. Some these analytical issues will be addressed in the next sections. But let us say something here in relation to the conceptualisation of good governance.

Like the concept of democracy, governance and its related concept good governance are “essentially contested concepts” (Landman and Hausermann 2003). However, although there is an established literature dedicated to assessing the validity of alternative ways of conceptualising and measuring democracy and its various dimensions and components,\textsuperscript{19} the field has not yet provided an equivalent literature devoted to discuss the concepts and methods of good governance.\textsuperscript{20} In this context, most of the cross-country studies on the institutional foundations of growth take the concept of governance and its operationalisation at face value. The lack of systematic discussion about the problem of transforming the concepts of governance and institutions into operational definitions is one of the most important shortcomings of this research programme.

Weiss (2000) shows that the definitions of governance used by international organizations vary substantially. For the OECD, governance denotes "the use of political authority and exercise of control in a society in relation to the management of its resources for social and economic development". Not surprisingly, the UNDP is more encompassing and views governance as "the exercise of economic, political, and administrative authority to manage a country's affair at all levels. It comprises mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences". In the same line, the UN Secretary-General claims that good governance is "ensuring respect for human rights and the rule of law; strengthening democracy; promoting transparency and capacity in public administration". The WBI assumes that governance is "the exercise of authority through formal and informal traditions and institutions for the common good, thus encompassing: (1) the process of selecting, monitoring, and replacing governments; (2) the capacity to formulate and implement sound policies and deliver public services; and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them".

These alternative definitions pose major challenges in terms of measurement and operationalisation. For one thing, all definitions aimed at encompassing concepts that are in themselves contested and difficult-to-measure such as democracy, human rights, accountability or political authority. For another, many of the dimensions of governance included in these definitions seem to be process or outcome variables. It can be argued that governance is by definition a political reality that involves rules, processes and outcomes. The issue is, however, that there is a tension here between such an approach and the institutions-as-constraints logic underpinning the claim that institutions do matter for economic performance. North (1990), who is probably the

\textsuperscript{18} Glaeser et al. claims that “human capital is a more basic source of growth than are the institutions” and that “poor countries get out of poverty through good policies, often pursued by dictators”.
\textsuperscript{19} See Munck and Verkuilen (2002).
\textsuperscript{20} For an exception to this rule, see the pioneering work of Landman and Hausermann (2003).
most cited author in the good-governance literature, defines institutions as the “humanly devised constraints that shape human interaction” and calls for the analytical distinction between the rules of the game (institutions), the players of the game (individuals and organisations) and the way the game is played. This important issue will be discussed in the next section.

In the last decade, the field of development research has witnessed an explosion of empirical studies showing that institutions do matter for economic growth. In the light of the arguments presented in this section, it should be also clear that the proposition that institutions play a significant role in explaining differential economic performance could be contested on conceptual and methodological grounds. Issues of endogeneity, omitted-variable biases and problems related to the method of operationalising governance are bound to question the validity of the econometric studies on institutions and growth. This situation may lead to scepticism about the real value of cross-country regressions in offering insights into the institutional foundations of economic development. Nevertheless, I would like to argue that the main deficit of this research programme is analytical and relates to our imperfect understanding of how politics interacts with institutions in shaping development policies and outcomes. As Helpman (2004) and North (2005) highlight, we do not have yet a developed body of theory capable of linking polities, institutions, institutional change and economic performance. In this context, it is important to reflect upon some of the analytical foundations of the comparative literature on good governance and prosperity.

2. Analytical Issues

“We cannot usefully model economic change until we understand the process. A good model entails a prior comprehension of the complex factors making up that process and then a deliberate simplifying to the crucial elements. Understanding is a necessary prerequisite missing in the economist’s rush to model economic growth and change”

Douglass North (Understanding the Process of Economic Change, 2005)

The objective of this section is to identify some of the analytical problems and gaps of the new econometric research on institutions and growth. This conceptual critique of the empirical literature will heavily draw on the ideas of North and other prominent neo-institutional scholars.

Distinguishing between policies and institutions

I suggested above that it is problematic to ignore the boundaries between policies and institutions. Let us discuss further this point. Olson’s (1996) main arguments in his now famous paper “Big bills left in the sidewalk: why some nations are rich, and other poor” are that “country’s institutions and economic policies are decisive for its economic performance” (theoretical proposition) and that “any poorer countries that adopt relatively good economic policies and institutions enjoy rapid catch-up growth” (normative proposition). Apart from being almost tautological, these propositions are problematic in the light of the insights of institutional theory, as one of its key analytical claims is the existence of a qualitative distinction between policies and institutions. Institutions are enduring entities that do not change easily at the will of the agents (Rothstein 1996), which implies among other things that the expected life of institutions (constraints) is much higher than the expected life of policies (Tsebelis
1990: 98). This often leads to the argument that alternative institutional arrangements may facilitated (or complicated) the negotiation and implementation of alternative policies through the definition of the structure of incentives and transaction costs.

From the perspective of new institutionalism, it is critical to draw a clear analytical line between rules and policies, and between choices given the rules or choices about the rules (Brennan and Buchanan 1985). In this context, the unqualified proposition that ‘good economic performance is a function of both policies and institutions’ is not without problems. To begin with, this proposition raises the methodological hazard associated with regressing income levels on policies and institutional quality (see the discussion in Rodrik et al. 2004). In addition, and more importantly, blurring the boundaries between institutions and policies does not help us to shed light on one of the central policy debates in the field of development, which relates to the question as to what extent governments should put the emphasis on building good institutions or on delivering good policies. On the one hand, some scholars support the idea that economic problems such as inflation, fiscal deficits and economic decline should be tackled through sweeping, and often self-binding, rule-based institutional reforms. On the other, some authors defend the view that good economic outcomes are achieved if sound fiscal, monetary and development policies are implemented on a day-to-day basis. We will see below that the ‘institutions versus policies’ debate is at the heart of the alternative interpretations of the East Asian miracle.

Unbundling politics and institutions

Another common problem is that of reading to much institutionalism into the proposition that institutions do matter for development. Take the example of Argentina, “the story of a decline unparalleled in modern times” (Della Paolera and Taylor 2003: 3). I asserted elsewhere (Dellepiane 2005) that an “institutionalist approach” is useful for shedding light on some crucial developments of the political economy of this country. However, I would like to argue here that the Argentine case is also useful for highlighting the limitations of a narrow institutionalist perspective. Argentina was one of the slowest-growing countries in the period 1960-1990, and bad governance was clearly related to such a dismal performance (Alesina 1998). However, to claim that poor institutional quality, reflected in poor standards of bureaucratic efficiency, corruption, property rights protection and the rule of law, is the key variable explaining Argentina’s growth collapse is to stretch the analytical reach of the institutionalist approach. One might question the robustness of the causal link running from institutions to growth by pointing out that both institutional decay and poor growth were embedded in profound politico-economic disequilibria. Some analyses suggest that politics and not institutions was the key factor driving Argentina’s economic underperformance. For example, Dornbusch and Di Tella (1989: 7) state that "[Argentina’s] economic problems have been affected by the political ones and by the complex problem of incorporating the working classes into the social, economic and political system". In similar fashion, Germani (1964) argues that Argentina experienced disequilibria between the processes of economic, political and social modernisation. Of course, institutional factors might have been important, but only if they were understood in a broader sense. For example, the seminal work of Mallon and Sourrouille (1974) stresses that in Argentina “accepted procedures or rules of the game do not exist for reconciling conflicting claims on limited resources generated by sector clashes and the struggle over distributive income shares".
The problem of analytical stretching also affects the comparative literature. For example, Feng (2000) uses the template of the political economy theory of growth to account for the economic performance of Pacific Asian countries. His central argument is that “political institutions” have a pronounced effect on growth, a claim that at first glance has a strong institutionalist flavour. Yet, a closer look at his work unveils a more nuanced scenario. Indeed, Feng shows that factors such as political stability, political polarization and government repression were the “political conditions” influencing economic growth in the region. In his landmark book *Democracy, Governance, and Economic Performance*, Feng (2003) also finds that political institutions (operationalised in terms of political repression, political instability and policy uncertainty) do matter for economic growth by constraining individuals’ decisions in their marketplace (Feng 2003: 296). It is difficult to disagree with this general proposition. However, as in the example of Argentina, the puzzle is distinguishing what is the political and what is the institutional embedded in the concept of “political institutions”. In my opinion, Feng’s work, as it is the case with much of the literature on the political economy of growth, is good at capturing the political context for economic development, rather than its institutional foundations.

Indeed, one may argue that this sort of modelling and measurement choices are oriented to capture the way politics, broadly defined, affect the “business environment” as perceived by domestic and foreign institutional investors.

*The core of the argument: the “structure” and the “structure-induced equilibrium”*

Neo-institutional theorists distinguish the “structure” from the “structure-induced equilibrium”, the latter being the equilibrium in outcomes induced by a given institutional configuration (Shepsle 1986; 1989). The problem here is that variables such as political stability, political polarisation and government repression are not measuring institutions-as-constraints, but institutional outcomes (if not political performance), as stressed by Glaeser et al. (2004). In Northean language, they are not referring to the rules of the game, but to the way the game is played by certain agents in different settings. The question, from an institutional perspective, is to identify what are the precise institutional rules (constitutions, electoral rules, economic regulations, social norms) structuring the behaviour of relevant economic and political actors. The problem is even more complicated. Institutions are the key variable explaining variation in outcomes under the assumption that preferences and tastes are fixed in the short-term (Riker 1980). However, analytical political science actually shows that both preferences and institutions may determine outcomes (Hinich and Munger 1997). And preferences do change across countries and time. In this context, the environment of political polarisation that hinders growth in many developing countries could be more associated with deeply rooted distributional and ideological struggles than with the institutional structure per se.

*The full implications of the Northean approach*

The Northean approach to institutions expands this analysis in several, and significant, ways. First, North (1990) claims that the structure that defines the set of incentives and opportunities in a given society (the “institutional matrix” in his language) is

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21 Indeed, the key assumption is that institutions affect the results of the game by mediating the way interests and preferences are translated into actual choices and outcomes.
composed not only by formal rules, but also by informal constraints and enforcement characteristics. Second, he argues that actors make choices based on subjective mental models, which means that “individuals from different backgrounds will interpret the same evidence differently [including the one provided by the structure of incentives] and in consequence make different choices” (North 2005: 62). Last, and clearly not least, North underscores the endogenous and political nature of institutions. According to this author, institutions may change, especially when shocks in relative prices induce organisations to believe that they could do better by altering the existing institutional framework at some margin. The agents of change are the political and economic entrepreneurs with the bargaining power to create new rules (North 1994).

One of the main analytical lessons of the Northean approach is that the real incentive structure of an economy is determined by both formal rules and informal constraints. A line of political economy research has sought to unveil the social conditions of development by studying the economic effects of norms of civic cooperation, interpersonal trust and social capital. For example, Knack and Keefer (2003), using data from the World Values Survey, claim to provide strong evidence that trust and civic cooperation have a significant impact on aggregate economic activity. Temple and Johnson (1998) also demonstrate that “social capability” is a factor of economic growth. However, our knowledge about the complex relationship between formal rules and informal constraints is still insufficient (North 2005), let alone our understanding of their combined effect in the process of economic development. North also remarks that “how the game is played depends not only on the formal rules defining the incentive structure for the players and the strength of the informal norms but also on the effectiveness of enforcement of the rules” (North 2005: 48, emphasis added). Econometric works on the economic effects of enforcement mechanisms are rare, given the obvious difficulties associated with measuring enforcement. Yet, we will see later that there is a growing and exciting game-theoretic literature on self-enforcing institutions.

Taking seriously the distributional sources of institutions

In a review of the new institutional tradition in comparative politics, Jonas Pontusson (1995) recommends researchers to “put political institutions in their place and take interests seriously”. In the light of the previous discussion, it is clear that this advice should be also taken into account by scholars working on the institutional approach to development. In one of his excellent essays on the political and institutional economics of development, Bardhan (2005: 27) claims that further research needs to uncover the relationship between “distributive conflicts” and “the persistence of inefficient institutions”. He also states that “the political stumbling blocks to beneficial institutional change in many poor countries may have more to do with distributive conflicts and asymmetries in bargaining power” (ibid, 30), a point that is consistent with the analytical message of North (1990), Tsebelis (1990), Knight

22 North (2005) stresses the role of beliefs and social learning in the process of economic change. See also Denzau and North (1994) and Knight and North (1997).
23 On the social conditions for economic growth, see also Inglehart (1997), La Porta et al. (1998), Whiteley (2000) and the discussions in Eggertsson (2005) and Mantzavinos (2001). There is also some interesting research on the negative effects of ethnic conflicts (Easterly and Levine 1997) and fractionalisation (Alesina et al. 2003) on economic growth.
Given that, institutions are not only means for mitigating collective-action problems, but also “weapons of coercion and redistribution” (Moe 1990: 213), research on the sources and effects of institutions and their role in the process of economic development should be based on the logic of power. Fortunately, the theme of the relationship between vested interests and institutional reforms is penetrating the good-governance research agenda (see Knack 2003 and Kaufmann 2003a).

Moving beyond a narrow and naïve approach to property rights

Bardhan (2005: 2) also contends that the field of institutional economics of development should move beyond the narrow focus on the undoubtedly important “institutions that protect individual property rights”. The bulk of his argument is that a wide range of political and social institutions can correct some of the pervasive coordination and co-operation failures involved in the process of moving from underdevelopment to development. This view is also consistent with the Northean approach. North emphasises the importance of private property rights and contract enforcement. However, he also stresses that institutions emerge to provide cooperative solutions to problems, and that therefore a variety of institutional arrangements may evolve to reduce transaction costs in impersonal exchange. In a not very cited paper, North (1999) criticises the privatisation experience of Russia and other Easter European countries (where the enforcement of private property rights did not seem to provide the right incentives), and contrasts it with the evolution of institutions in the fast-growing China. On the experience of China, he concludes that:

“There are lots of different ways to achieve wealth. There are lots of different ways to structure the game, to provide the correct incentives (that is what institutions are, incentives structures) to do the right thing” (North 1999: 23).

The comparative literature on institutions and growth also relies on a naïve and ahistorical understanding of private property rights. Although authors often stress that secure and stable property rights are good for growth, they seldom discuss the critical issues of how property rights emerge and evolve in particular countries, the distributional consequences of such evolution for different social groups and the political legitimacy of alternative property structures. Similarly, some of the unpleasant trade-offs implicit in the idea of protecting property rights are often ignored. For example, what are the implications of protecting property rights in contemporary Brazil, where there is an historical distributional struggle between over-represented landowning elites and underrepresented landless peasants? In the same fashion, what are the implications of respecting private contracts and rights in countries like Argentina, Bolivia and Russia, where pervasive corruption polluted the very privatisation processes that granted such rights? Similarly, scholars interested in highlighting the supposed economic benefits of good governance often overlook the disturbing reality that a restricted and selective protection of property rights has been the source of high growth in many countries in the past.


See, for example, the work of Haber et al. (2003).
Credible commitments and self-enforcing institutions

North (1993) argues that “credible commitment” is the most pressing issue for developing countries. The problem of credible commitment is at the heart of what Weingast calls the fundamental political dilemma of an economy, namely that “a government strong enough to protect property rights is also strong enough to confiscate the wealth of its citizens” (Weingast 1995: 1; see also North et al. 2000). Given this old Hobbesian dilemma, sovereign governments need to make credible commitments towards protecting property rights, observing the rule of law and providing the political basis for economic growth. The problem is that, in the absence of specific conditions, a “wealth-creating game” (Mantzavinos 2001) is not an equilibrium. On the contrary, throughout history the presence of such conditions has been the exception rather than the rule (North 1993; Olson 1996). Yet, political economists have shown that governments may create incentives for maintaining agreements and promises through time by adopting “pre-commitment strategies” (Levi 1988), which often involves the building of institutions.26 As Mantzavinos (2001: 245) concludes, “in order to establish a wealth-enhancing game, a government must provide the appropriate formal institutions and credibly commit to them”.

A narrow property-rights perspective, focusing on the transactions between rulers, asset-holders and investors, usually informs the discussion on the relationship between institutions and growth. Yet, the creation of the political conditions for economic growth involves the solution of multiple credible-commitment problems. For example, Campos and Root (1996) show that the way governments made credible their commitments towards the strategy of “shared-growth” has been the key to the Asian miracle. On the one hand, East Asian leaders won the co-operation of economic elites for the implementation of growth-enhancing policies by establishing “institutions, rules, and procedures that limited government discretion over economic policy” (Ibid: 7). On the other hand, the East Asian leaders introduced sweeping “wealth-sharing mechanisms” aimed at signalling non-elites that they would share the benefits of economic growth. This underlines the importance of integrating the ‘politics of accumulation’ and ‘the politics of redistribution’ in studying the links between credible commitments and growth. Credible commitments are more relevant if the aim is to achieve sustained economic growth in the context of democratic governance. Carles Boix (2003) demonstrates that credible commitment relates to the problem of democratisation. Whether democracy is a self-sustaining equilibrium depends on the existence of conditions by which the wealthy elites can make credible commitments towards free and fair elections, and the poor towards moderate levels of redistribution. Using a similar logic, Weingast (2002) shows that one of the factors explaining ethnic conflict, a problem that undermines the possibilities of both democratisation and economic development, is actors’ impossibility to sustain credible commitments regarding the protection of the rights of minorities.

Institutions are endogenous

As mentioned before, one of the fundamental contributions of the Northean approach is to highlight the endogenous nature of institutions. In general, empirical works on institutions and growth have dealt with the causality problem by trying to control the

impact of wealth on institutional quality. However, the problem of endogeneity goes beyond the question of whether relatively poor countries can afford good institutions. The critical issue is that the very institutions that constrain behaviour by providing a system of incentives are human choices themselves. In a world of endogenous institutions, we must face up the challenge of moving from a theory of institutional equilibrium (the equilibrium in outcomes induced by a specific institutional configuration) to a theory of equilibrium institutions (the process by which rules are created and sustained) (Shepsle 1986, 1989).

The conventional approach within new institutionalism has been to divide the study of institutions into two level of analysis: a very active research programme looking at the question of “institutional effects” and a second, far less developed, line of inquiry dealing with the theory of endogenous institutions (Weingast 2002). The pre-eminence of the former approach is the consequence of the intrinsic complexity of “modelling games with variable rules” (Tsebelis 1990), but also of the assumption that any attempt to explain the origins and survival of institutions should be based on a prior knowledge of their effects (Weingast 2002). In my opinion, the reverse side of the latter assumption is also relevant. We can propose that any explanation of the way institutions contribute to the process of economic development should be based on a better understanding of the forces shaping the origins and evolution of such institutions. This is critically important for comprehending the way politics mediate the relationship between institutions and economic performance, and for predicting some of the unintended consequences involved in the process of institutional and economic change. It is worth noting that econometric research is increasingly focusing on the economic and political determinants of good governance. What is missing, and will be missing for some time, is a solid understanding of how economic and institutional processes evolve and interact dynamically (North 2005).

Caporaso and Levine (1992: 7, emphasis added) introduce the political economy approach by observing that: "it is often assumed that political economy involves an integration of politics and economics. It is less often conceded that the very idea of political economy rests on a prior separation of politics and economics". This observation is valid for our discussion. The political economy of growth invokes the integration of economic, political and institutional factors to explain growth paths across countries. In this section, I have argued that this analysis should rest not only on a prior separation of economics and politics, but also on an analytical distinction between the political and the institutional often collapsed within the concept of governance. Building on new institutionalism, I have also argued that we need to distinguish between the rules of the game (both formal and informal), the beliefs, interests and strategies of the players, and the play of the game. Neo-institutionalist scholars also call for a clear distinction between transactions given rules and choices about the rules. In this context, I have asserted that the discussion on the economic effects of good governance should acknowledge the qualitative distinction between policies and institutions, on the one hand, and deal with the political and distributional sources of good institutions, on the other. The next section focuses on some policy implications of this analysis.

3. Policy Implications

“The new institutional economics has made good progress in analyzing the role of institutions in shaping economic outcomes, but the field has made less headway formulating clear principles of institutional policy in many crucial areas”

Thrainn Eggertsson (Imperfect Institutions: Possibilities and Limits of Reforms, 2005)

The institutional political economy of growth is a research programme with strong public policy connotations. The purpose of this section is to discuss the policy implications of the comparative literature on institutions and economic performance in the light of the analytical critique presented above. In particular, the aim is to assess the plausibility of the good-governance approach to development implied in the discourse and actions of international organizations.

In the last decades, governance and increasingly good governance “have permeated development discourse and especially research agendas and other activities funded by public and private banks and bilateral donors” (Weiss 2000: 796). Indeed, the publication of the 1997 World Development Report (The State in a Changing Word) signalled a pivotal change in the development game. This work claims that an “effective state” is vital for the provision of good and services, and the rules and institutions, that allow markets to flourish and people live healthier and happier lives. Hence, “good government is not a luxury; it is a vital necessity for development”. Similarly, at almost the same time, the International Monetary Fund (IMF) declared that “a much broader range of institutional reforms is needed if countries are to establish and maintain private sector confidence and thereby lay the basis for sustained growth” (IMF 1997). Another turning point took place at the time of the International Monetary Fund/World Bank Annual Meetings in late 1996, when “the President of the World Bank placed the corruption issue center stage as a worldwide challenge for development, which was followed by support from the IMF and other institutions, complementing the work of the leading NGO in the anti-corruption arena, Transparency International (TI)” (Kaufmann 2003).

What is the good-governance approach to development? At its simplest, this approach implies the application of the proposition that “institutions do matter” in the realm of development research and policy. A priori, this appears as a natural state of affairs in the context of the neo-institutional revolution in social sciences and the concomitant proliferation of empirical works establishing a positive link between good institutions and development outcomes. Yet, this story about the evolution of ideas is incomplete without an understanding of the political context that shaped the conditions for the rise of a good governance discourse in the international public policy game. Actually, an explicit concern about good governance and its implications for development emerged in the framework of the reformulation of the Washington Consensus, which was prompted by some of the disappointing outcomes of the first generation of market-oriented reforms.29 As Kaufmann (2003a: 3; emphasis added) acknowledged,

"Less than a decade along, governance issues did not figure prominently in the agenda of international financial and development institutions. Then there was no road: the absence of institutional and governance reforms was arguably the most glaring omission of the Washington

29 More critically, one may argue that the rise of the good-governance discourse aimed at legitimising the new politics of development. A critical assessment of the new politics of development is provided in Kothari, U. and Minogue, M. (Eds) (2002).
Consensus of the past decade on the 10 tenets of sound economic policies and management. In fact, the challenges of governance and corruption were often ignored altogether.

Having clarified these issues, let us discuss some of the policy implications of the comparative literature on good governance and development. Alberto Alesina’s article ‘The political economy of high and low growth’ is a good example of an empirical work on institutions and growth with strong normative implications, which was reinforced by the fact that it was presented in the 1997 Annual World Bank Conference on Development Economics. Using information from a sample of 102 countries for the period 1960-1990, Alesina (1998) claims that “institutional quality - as measured by bureaucratic efficiency, absence of corruption, the protection of property rights, and the rule of law- is important for growth”. In the light of this finding, this scholar makes the case for “institutional conditionality”:

“Given that foreign aid typically increases government consumption [which does not seem to improve social indicators or reduce poverty and inequality according to the author], the World Bank and other international organizations should consider withdrawing financial and technical assistance from countries that do not satisfy minimum standards of institutional quality. Cutting off assistance may increase growth and foster social development in the medium run by creating incentives for institutional development”.

The argument for institutional conditionality advocated by Alesina is based on the following two claims. Firstly, there is the usual (institutionalist) proposition that, under certain conditions, good institutions are a factor of economic development. Secondly, there is the (conditionality) claim that cutting of assistance to countries observing poor governance records may create incentives for institutional strengthening via standard moral hazard considerations. Given that institutional conditionality has become a sort of conventional wisdom within some international organisations providing advice, technical assistance and development aid, it would be appropriate to discuss the validity of this argument.

To begin with, one may question the validity of Alesina’s normative claim in the name of methodological concerns. For example, building on the concerns of Glaeser and his colleagues, one may object the method of using perceptions-based indexes of institutional performance to establish a causal relationship between institutions and economic outcomes. Similarly, one may argue that such a strong normative inference is unwarranted given the limited time-frame of the study. But let us assume, for the sake of the argument, that Alesina’s analysis is free of any serious modelling or measurement problem. Even in this case, advocating conditionality is not without problems because moral hazard arguments might not travel well from textbooks to the reality of developing countries. Institutional conditionality is even more problematic from a Northean perspective. Given that the actual incentive structure of a society is composed of formal rules, pervasive informal constraints and enforcement characteristics, it is very difficult to predict the ultimate outcome of an attempt to create incentives for institution-building through the manipulation of financial aid. Since unintended consequences are likely to come into play, the challenge is to demonstrate that cutting-off financial assistance would increase the probability of governance-enhancing reforms becoming self-enforcing. As the history of economic

30 The analysis does not cover the critical 1990s or the periods in which most of the today rich countries became developed.
31 On the difficulties associated with enforcing conditionality, see Drazen (2000).
sanctions and foreign interventions shows, the application of the conditionality clause may lead to unforeseen events depending on the way domestic politics mediates the process linking aid with institutional reforms.\textsuperscript{32}

Another critical issue to take into consideration is the likely response of the political stability variable, which has significant effects in Alesina’s regressions. It is not difficult to imagine that, in many cases, the application of conditionality may lead to the deterioration of both governance and economic performance through the political instability channel. This brings us to the work of Feng (2003). Although that study stands as one of the most comprehensive and innovative approaches to the empirics of governance and economic performance, it reveals the uncertainties associated with translating the findings of cross-country studies into usable lessons for institutional policy. The chief policy implication of his work is that “a nation can achieve ‘economic miracles’ by reducing political instability, building policy certainty, and increasing political freedom” (Feng 2003: 37). The puzzle is to identify what set of institutional reforms, and at which level, a misgoverned country should implement in order to strengthen the political foundations of its economic system. The real problem is that, as suggested before, factors such as political stability and policy certainty are outcome-variables that reflect more the way the political game is played across countries than the actual formal institutional arrangements structuring that game.

The measurement strategy chosen by Feng also raises some pressing questions regarding policy implications. For example, he measures the level of policy certainty/uncertainty, one of the key variables driving his findings and their related normative implications, through indicators of income distribution (GINI coefficients) under the plausible assumption that a high degree of wealth disparity polarizes societies, promotes conflict and undermines consensus-building around policies. Indeed, the method of using measures of income inequality as proxies of governance-related concepts is common in the political economy of growth literature. In principle, there is nothing intrinsically wrong with such a measurement strategy provided that it is supported by theory. The issue is, however, that one may build on the observed relationship between income distribution and economic growth to construct a competing (read less institutionalist) narrative from the one provided by Feng. As a result, it is not easy to read the policy lessons of some of Feng’s results. This author finds, for example, that “political instability and policy uncertainty underscore the lack of economic performance in Latin America” (Feng 2003: 86). Given the strong links between misgovernance, high inequality and poor growth, and between, it remains unclear whether Latin American countries should put the emphasis on institution-building or on tackling poverty and inequality.

Knack (2003: 294) acknowledges that existing research showing that governance matters for development “does not often point the way toward specific reforms, because it is based largely on very broad and aggregated indicators of institutional

\textsuperscript{32} Another critical problem relates to the distributional implications of institutional conditionality. Which actors are going to bear the burden of the policy? What is the role and bargaining power of those actors in the game of institutional change?
performance”. As mentioned above, the real problem is that those aggregated indicators of governance are not even measuring the institutions per se, but the structure-induced equilibrium. Take the example of corruption. Since the work of Mauro (1995), a growing empirical literature has shown that corruption has growth-retarding effects (Ades and Di Tella 1996; Tanzi 1998). The complicated issue is again how to draw the right policy lessons from this empirical finding. In many developing countries, high levels of corruption are an equilibrium outcome induced not only by the formal rules of the game, but also, and fundamentally, by the incentives embedded in deeply rooted political practices, informal norms and beliefs. In addition, pervasive corruption is likely to flourish and stick in the context of poverty and inequality. In this context, it is not evident what kind of legal, institutional and public sector reform would be effective in curbing corruption in developing countries. As Rodrik (2003: 8) highlights:

“Once one moves beyond general statements of the kind that property rights are good for growth and corruption is bad, there is much that remains unclear. Which institutions demand priority? What are the specific institutional forms that are required? Do these differ across countries according to the level of development, historical trajectory, and initial conditions?”

The case of corruption is also appropriate for underlining the role of politics and distributional factors in shaping the relationship between institutions and economic outcomes. For example, Kaufmann (2003a) remarks that corruption may be also promoted by the behaviour of multinationals and powerful economic elites seeking undue influence in the policy process. At the policy level, this author questions the effectiveness of a narrow technocratic approach to anti-corruption and proposes instead a bolder and more encompassing framework for confronting the challenge of “state capture”. The key assumption guiding his work is that addressing governance issues requires an understanding of the “complex political dynamics” in which misgovernance takes place. In turn, this would demand moving beyond the blanket treatment of ‘politics-as-an-obstacle’ of governance reforms and abandoning the untenable assumption that the success of a given reform process depends on the “willingness” of particular political elites. The lack of focus on the constraints governing the process of economic and institutional change is clearly one of the most serious omissions of the good governance approach to development. As Knack (2003: 295; emphasis added) states:

“Despite the widespread recognition of the fundamental importance of governance for development within agencies such as the World Bank and UNDP, the country assistance strategies of donors are rarely based on a thorough political economy analysis that identifies the binding political and social constraints on development and proposes ways to overcome them or work around them effectively”

Eggertsson (2005) contends that comparative institutional analysis should be more active in studying the “possibilities and limits” of institutional reforms. A good starting point to approaching this issue is to take seriously the implications of path dependence, a concept which has been often misinterpreted and disqualified as too deterministic, economist and apolitical. According to North (1995), path

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33 With the aim of unbundling particular manifestations of misgovernance and corruption, the World Bank and other organisations have begun to develop cross-country surveys and in-depth in-country governance diagnostics (Kaufmann 2003a).

34 See also Pierson (2004).
dependence need not have deterministic connotations. It simply means “constraints on the choice set”. The key constraints are distributional and cognitive. Politico-economic processes are path-dependent because large-scale changes usually undermine the interests of groups with high stakes in the status quo, but also, and importantly, because shared mental models limit actors’ choice set by defining the range of perceived legitimate change. As suggested before, several development experts are increasingly underscoring the role of distributive conflicts and special interests in constraining the process of building good governance (Kaufmann 2003, Knack 2003 and Bardhan 2005).

In his last book, North stresses that beliefs are at the core of the processes of institutional and economic change. More precisely, he argues that the elaborate structure of institutions that determine economic and political performance is the result of beliefs and the way they are altered by feedback from changed perceived reality (North 2005: 4). The theme of the critical relationship between cognition and institutions does not seem to have a prominent place in the good-governance agenda of international organisations. This is probably due to the analytical and methodological hazards involved in modelling and measuring cognitive-related processes. Most probably, the international community might prefer to overlook the question of whether beliefs are a binding constraint for development in order to avoid the sensitive issue of cultural determinism. Yet, as suggested above, North’s fundamental message has nothing to do with determinism. It is about the importance of understanding how evolving mental models constrain the choice-set of the players engaged in the process of institutional change. Comprehending the way key actors “perceive” the world around them is critical for making sense of the scope for institutional innovation. In North’s (2005: 163-4) words:

“In order to improve the institutional structure we must first have a clear understanding of the sources of such institutional structure…We must have not only a clear understanding of the belief structure underlying the existing institutions but also margins at which the belief system may be amenable to changes that will make possible the implementation of more productive institutions” (North 2005: 163-4).

We can conclude this section by referring to one of the traditional debates in development policy: whether countries should adopt a shock or a gradualist strategy of institution-building. During the 1990s, many economists and experts within international organisations endorsed a bold, comprehensive and orthodox approach to structural reforms. However, one of the most important lessons that emerge from the country narratives included in Rodrik (2003: 15) is that “the onset of economic growth does not require deep and extensive institutional reform”. Their findings raise interesting questions regarding the scope, sequencing and pace of the reform efforts needed to sustain long-term economic growth. The good-governance game seems also to be moving away from orthodoxy. For example, Rodrik and its contributors conclude that the acquirement of good institutions often requires “experimentation,

35 As Margaret Levi (1997: 28, emphasis added) explains: "path dependence has to mean, if it has to mean anything, that once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct any easy reversal of the initial choice".

36 The social-capital-for-development research programme seeks to fill this analytical gap.

37 In my opinion, studying the mental models of the players is also important for understanding some of the sources of the imperfect enforcement of formal institutional reforms.
willingness to depart from orthodoxy, and attention to local conditions” (Rodrik 2003: 12). Kaufmann (2003a) also makes the case for “rethinking governance” and “challenging orthodoxy”, not least because empirical research shows that most developing countries have made scant progress in controlling corruption, strengthening the rule of law and improving institutional quality since the rise of the good-governance agenda.

4. Lessons from East Asia and Latin America

One of the key patterns that emerge from the empirical studies on economic growth is that of the contrasting experiences of Latin America and East Asia (or a sub-set of East Asian countries). For example, seven of the eleven countries labelled by Knack (2003) as “catch-up countries” on the merits of their per capita income growth in the period 1960-1998 are from East Asia (Singapore, Hong Kong, Japan, Taiwan, Korea, Malaysia, and Thailand) and not even one is from Latin America. Not surprisingly then, many Latin American countries are in the undesirable category of “fall-back countries”, a group where countries like Argentina, Uruguay, Venezuela, Nicaragua and Peru show the most depressing tales of relative economic decline.38 These contrasting outcomes are even starker when it comes to income inequality. While the high-performing Asian economies (HPAEs) have achieved impressive results in terms of improving income distribution in the context of a successful shared-growth strategy, Latin American countries continue at the top of the world rankings of inequality. Even Chile, Latin America’s growth star in the last twenty years, has still very high levels of inequality (though poverty has declined markedly).39

An extensive literature has looked at the sources of the so-called East Asian miracle, the causes of Latin America’s depressing growth tale and the contrasting development paths of both regions.40 This is not the place to put together a comprehensive review of the political economy of Latin America and East Asia’s divergent growth paths. However, what we can do is to take up some issues from the comparative experiences of these regions and related them to our discussion. More specifically, we can reflect upon the question of whether the experiences of Latin America and East Asia in the post-war period tell us something about the relationship between governance, institutions and growth. In order to be consistent with the chief aims of this article, the discussion will focus on analytical issues and policy implications.

As suggested in Section 2, the ‘institutions versus policies’ issue is at the core of the debate about the causes and implications of the East Asian miracle. Using the analytical framework provided by Glaeser et al. (2004), the key question here is whether the impressive economic performance of a subset of Asian countries in the post-war period has been the result of the “policy choices” made by their (mainly authoritarian) governments or of the “institutional constraints” placed on them. This issue remains a divisive one. On the one hand, the works of Alesina (1998), Feng (2000, 2003) and many others seem to suggest that good political institutions and secure property rights are the keys of economic success. On the other hand, Glaeser

38 See also Alesina (1998) and Feng (2003).
39 As Fajnzylber (1990) showed, the impossibility of reconciling growth and inequality reduction has been one of the long-term patterns of Latin American development.
et. al. (2004) argue that the sustained growth achieved in some Asian countries (including China) has been the outcome of the policy decisions taken by their leaders, and not of the institutions constraining them (see also Rodrik 1994). This debate is relevant for Latin America, where the pendulum of the “war of ideas” appears to be moving towards the ‘policy’ approach, in the context of the disappointing results of the first generation of structural reforms implemented during the 1990s and the political realignment that has been taking place in the region.41

The comparison between East Asia and Latin America also reveal the problem of reading too much institutionalism into the proposition that good political institutions are the main sources of economic development. We can illustrate this point by focusing on one of the most significant explanatory variables of the political economy of growth literature, political stability. The concept of political (in)stability is undoubtedly one of the key variables accounting for the politico-economic sources of growth in many studies (Alesina 1998), and explaining the contrasting economic performances of East Asia and Latin America (Feng 2003). But, as mentioned before, we can hardly use this evidence to support the existence of a conceptual link running from institutions to growth, without committing the sin of analytical stretching. Political instability has been evidently one of the expected features of Latin American development. However, this outcome seems to have been more associated with pervasive politico-economic disequilibria than with the virtues of formal rules of the political game. Therefore, it is unclear what sort of policy lessons one should draw from the existence of a link between political stability and growth, especially once the old debate about the relative merits of presidential and parliamentary regimes has run out of steam. The challenge is demonstrating that a given institutional reform may strengthen the sources of both political order and long-term economic growth.42

We can illustrate this point by discussing the case of Bolivia, one of the poorest and most unstable countries in Latin America. It is clear that misgovernance has been both the source and the consequence of the economic underperformance of this country. However, it is less clear what a country like Bolivia should learn from the literature on institutions and development. One potential answer is provided by Mantzavinos (2001: 245), who asserts that, “secure property rights and economic institutions maintaining open markets are the appropriate formal rules for a wealth-creating game”. However, as North (2005) points out, the transplant of market-friendly institutions to the third world has frequently altered income distribution and generated political instability, leading to downstream consequences that were the reverse of the intended objective. Bolivia has recently undergone a new perverse cycle of political instability and slow growth, which was precisely rooted in political contestation against elites’ intentions to extend private property rights to key areas such as mineral resources or water provision. We are not neglecting here that, under certain conditions, secure property rights may provide the right incentives for growth by favouring production over predation, as suggested by Knack (2003). The problem is that Keefer and Knack (2002) also shows that social polarisation reduces the security of property and contract rights and, through this channel, slows growth, and that inequality reduces growth in part through its effect on the security of property rights.

41 Nowhere is this pattern clearer than in Argentina, where the collapse of the convertibility system in 2001 destroyed the public reputation of self-finding structural reforms and led to the adoption of a discretionary approach to policymaking.
42 North et al. (2000) discuss the sources of order, disorder and economic change.
The key political question is how to make wealth-creating economic institutions self-enforcing. Henisz (2000) claim that an institutional environment with many “veto players” induces economic growth by creating a credible commitment for non-interference with private investment and property rights. But this argument seems to overlook the historical dynamics of the process linking institutions and growth. As Tsebelis (2002: 204) stresses, it is not clear whether many veto players will lead to higher or lower growth, “because they will lock a country to whatever policies they inherited, and it depends whether such policies induce or inhibit growth”. In this context, one might even think about a conflict between the checks-and-balances type of accountability implicit in some notions of good governance, on the one hand, and executive effectiveness in implementing pro-growth institutional reforms, on the other.43 Weingast (1995, 1997) argue that a constitution, which respects the rule of law and the principles of market-preserving federalism, has been the most frequent commitment device used to restrain governments from violating property rights. The issue is that many US-like constitutional provisions have not been self-enforced in Latin America (North et al. 2000), where the beliefs and institutions of patrimonialism have continued to define the incentives of the political game.

As institutional solutions to credible commitment are themselves subject to problems of credible commitment (Bardhan 2005: 62), some political economists put emphasis on modelling the conditions that support self-enforcing institutions (Weingast 1997; Boix 2003). The question of what set of conditions makes possible the signalling and enforcement of alternative commitment strategies is relevant for our discussion on the political economy of East Asian success. We have seen above that a number of multiple credible-commitment mechanisms, involving political transactions between governments, economic elites and citizens at large, made viable the shared-growth model. But Campos and Root (1996: 2) also remarks that “a geopolitical environment characterized by the high risk of insurrection explains the urgency of finding a cooperative solution to economic growth in East Asia”. As a case in point, it is clear that the implementation of some of the wealth-sharing mechanisms (notably land reform) was eased by the threat of communist takeover, made credible by a successful peasant-based revolution in China.44 It is also indicative that the other high-performing countries in Knack’s table are Ireland, Spain and Greece. This seems to suggest that the process of European integration has provided a commitment device to less-developed European countries seeking to reconcile democracy and growth.

It can be hypothesised that in the absence of these facilitating geopolitical conditions the strategy of shared growth in East Asia, and the path of democratisation with socioeconomic progress in the European periphery, could have been out of equilibrium. What are the analytical implications of the ongoing discussion? The first lesson is that international political economy (IPE) matters. Scholars working on different areas of comparative politics have stressed the role of external opportunities and threats in supporting the rise and sustainability of institutional equilibria (Riker 1964 and Boix 2003). In addition, one of the most promising research agendas within the IPE tradition explores how the interaction between international and domestic factors affects national economic policies and outcomes (Frieden and Martin 2002). For example, some scholars have studied how domestic politics and institutions

43 Philip (1999) analyse this issue from a Latin American perspective.

44 On the geopolitical sources of the East Asian miracle, see Stubbs (2005).
mediate the relationship between globalisation and policy change (Garrett 1998, Swank 2002). It is clear that future scholarship on the political economy of growth should build on some of the insights offered by the IPE approach. The second lesson is that research on the effects of institutions on growth must include an analysis about the conditions (both international and domestic) under which productivity-enhancing institutions are likely to emerge and be sustained in equilibrium. As Grief (1998: 60) argues, evaluating the impact of particular institutions on economic growth requires “examining them in the broader context of the factors influencing the extent to which the political system is self-enforcing”.

It seems that the crucial issue is how politics interact with institutional development in shaping the conditions for economic growth. One way to put back institutions into the debate is by looking beyond the conventional property rights approach. For example, in their work on East Asia, Campos and Root (1996) put emphasis on the institutions that supported credible commitments between governments, elites and citizens. On the one hand, these authors shows that the cooperation of powerful economic groups was gained by the creation of “institutions that facilitate the exchange of information between the public and private sectors” (ibid, 78). On the other hand, Campos and Root argue that East Asian regime leaders also responded to the challenge of economic growth by designing “institutions that spread the benefits of growth-enhancing policies widely” (ibid, 1). Rodrik (1998) considers that domestic social conflicts often cause growth collapses and stresses the role of the “political institutions of conflict management” in determining how domestic conflicts triggered by external shocks are resolved. The implications of “adaptive efficiency” should also be relevant for Latin America, a region that has experienced stop-and-go institutional development and growth for centuries. North (2005: 78) claims that one of the key sources of long run economic success is adaptive efficiency, which implies:

“A set of institutions that readily adapt to the shocks, disturbances, and ubiquitous uncertainty that characterize every society over time”.

The good-governance approach to development should not ignore the issue of the political management of economic change and its institutional implications. Recent developments in Bolivia, Ecuador, Argentina and many other Latin American countries have eloquently shown that many reforms oriented to strengthen property rights involve an unpleasant trade-off between pro-productivity policies and social conflict, which often leads to unintended consequences in terms of both growth and property rights protection. This unpleasant trade-off is implicit in many empirical works. For example, Gwartney et al. (1996) and Wu and Davies (1999) find that it is economic freedom that really matter in economic growth. However, political economists should never forget that "markets constitute a powerful source of sociopolitical change and produce equally powerful responses as societies attempt to protect themselves against market forces" (Polanyi 2001). The question is that policies

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45 Kaufmann (2003b) discusses some global constraints on governance and development.
46 Eggertsson (2005) shows that “favourable background factors” conditioned Botswana’s economic miracle. On the experience of this country, see Acemoglu et al. (2001b). It is also clear that strong economic growth in Chile (Latin America’s success story) has been also supported by specific political conditions facilitating the rise and survival of credible commitments.
47 They describe, for example, the working of the “consultative committees” that were used in Singapore, Thailand, Korea, Japan and Malaysia.
48 Thelen (2003) highlights that institutional stability involves a great deal of “institutional adaptation”.

aimed at increasing economic freedom will have the expected effects only if governments are able to articulate politically the introduction and enforcement of wealth-creating reforms. Institutions may play a key role in this process by affecting the ability of governments to accommodate change. However, let us remember that, as the concept of adaptive efficiency supposes, sometimes “institutions too have to change in order to promote growth” (Helpman 2004: 140).

The case of East Asia also stresses the interdependence of the processes of accumulation and distribution. One of the most dynamic research lines in the political economy of growth has focused on the effects of income inequality on growth via the implied political pressure for redistribution (Drazen 2000). It is worth observing that it is increasingly accepted in this literature that poor income distribution harms economic growth through both economic and political mechanisms, including the so-called political instability channel (see IADB 1999). Consequently, it is not surprising to see the emergence of a new conventional wisdom pinpointing the existence of virtuous circles between poverty reduction and growth and advocating pro-poor growth policies. We can close this cycle by highlighting that recent empirical studies have found a strong causal effect running from income inequality to bad governance (Chong and Gradstein 2004). In the light of this new evidence, it is not unreasonable to think that East Asia’s shared-growth model should be a good template for Latin America, which is precisely trapped in a perverse cycle of high inequality, bad governance and slow growth. Yet, is East Asia the right model for Latin America?

Clearly, political instability, the (un)rule of law, stop-and-go growth and the social deficit are entangled in Latin America. For one thing, in the context of pervasive poverty and inequality, large sectors of the population are either unwilling or unable to defend the institutional limits on the state. For another, the background of extreme social polarisation determines that the strategic interactions between elites and non-elites will hardly lead to self-sustained political order and economic growth. In this context, more progressive fiscal pacts seem to be necessary preconditions for building social consensus and political legitimacy around a wealth-creating game. Yet, this process is likely to involve tough constraints. Some of the pressing questions are how to implement a strategy of ‘shared growth’ a la East Asia that would not degenerate in the traditional macroeconomics of populism, or how to introduce effective wealth-sharing mechanisms that would not become trap in the traditional networks of clientelism and patronage. Most importantly, the existence of potential virtuous circles of inequality reduction and growth should not lead us to depoliticise the redistribution debate. It is one thing to recognise that inequality retards growth and corrupts governance in poor countries; it is a completely different thing to ignore the fact that the interests and beliefs of key elites are bound to constrain the transition towards a new distributive equilibrium.

This brings us to the problem of path dependence. Some scholars argue that the possibilities of Latin America’s development have been constrained by the lingering effects of the extractive and patrimonial institutions enacted in the region during the colonial period (Engerman and Sokoloff 2000; Acemoglu et al. 2001a). This thesis can be contested by arguing that a great deal of variation in terms of economic and political outcomes has been actually observed in the region, both across countries and

time. It can be also pointed out that the history of Latin America is rich of examples of political agency seeking and achieving change. However, the implications of institutional path dependency cannot be rejected altogether. There is little doubt, for example, that Latin America’s scandalous levels of inequality (the highest in the world) have their roots in the economic and political structures of the colonial past. Breaking with history is possible, and obviously desirable, in this case (see IADB 1999). Yet, the lesson is that future efforts oriented to design pro-poor and pro-growth governance capacity in Latin American countries should be sensitive to the way evolving distributional and cognitive factors limit the range of feasible and enforceable institutional reform, and also to the way formal rules and informal constraints interact in shaping the process of economic development.

Before concluding this section, I would like to state that the analysis of the divergent development paths of East Latin and Latin America emphasises the importance of understanding economic development as a process.\(^{50}\) It seems clear that some countries (including most in Latin America) are trapped in a historically rooted bad equilibrium of misgovernance, stop-and-go growth and high inequality. On the other hand, another group of countries has managed to break with history and achieve sustained growth and tame poverty through the consolidation of wealth-creating policies and institutions. The critical issue is that, in most of the successful cases, the process that led to the creation and sustainability of the political and institutional conditions for economic growth became self-enforcing in the context of very specific historical, domestic and international conditions. More specifically, the memory of bloody civil wars, the legacy of long dictatorships, the threat of communist takeovers, processed of economic and political integration and the direct involvement of powerful geopolitical actors have been some of the factors facilitating the sustainability of credible commitments and growth in countries such as South Korea, Taiwan, Spain and Chile.

Assuming that ‘development is a process’ does not mean neglecting the role of theory-informed research in delivering policy lessons. Drawing lessons from the past is always a risky exercise. Knack (2003: 292) argues that “the paths taken by nations that are wealthy today provided limited guidance for promoting rapid political and economic progress in less developed nations”, probably because today we expect, fortunately, to achieve development in the context of higher standards of democracy, human rights protection and interstate justice. Still, we can, and should, learn lessons from the past, which is the implicit assumption underpinning much of the research in comparative political economy. The challenge is striking the right balance between a naïve one-size-fits-all approach, on the one hand, and an uninformative everything-depends-on-local-conditions one, on the other. Some of the facilitating conditions that led to the emergence of credible commitment and growth in the past are not replicable, and not even desirable. We have seen that explicit wealth-sharing devices eased the political conditions for economic growth in East Asia, and that redistributive policies were possible given particular domestic and geopolitical circumstances. We also know that the rise of the welfare state and progressive taxation smoothed the process of reconciling capitalism and democracy in today developed countries, and that that fiscal pact was possible in the context of specific internal and external threats. For many, those experiences are irrelevant for developing countries because

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\(^{50}\) For an approach to economic development as a process, see Cypher and Dietz (2004).
the present environment discourage the possibility of redistribution via taxation or land reform. In my opinion, the crucial issue is recognising the main lesson of the past: the important role that policy-generated political legitimacy has had in facilitating the process of economic development. Having acknowledged this lesson, we can start thinking about which policies and institutions are suitable to address the legitimacy gaps of pro-growth reforms, and about which global and domestic governance changes are needed to “approximate” the political conditions that sustained the marriage between growth and social progress in successful cases.

5. Conclusions

“Not only does governance matter, but research contributing to our understanding of governance matters”

Stephen Knack (Democracy, Governance and Growth, 2003)

This article has not sought to unveil “the mystery of economic growth” (Helpman 2004). It is far beyond the scope of this paper to pretend to solve the puzzle that preoccupied political economists since the days of Adam Smith. The chief concern of this essay has been to apply some analytical thinking to the comparative literature on institutions and growth. By doing so, we have also put into question some of the assumptions underpinning the increasingly dominant good-governance approach to development. In addition, the analytical gaps and policy implications of the institutional political economy of growth have been discussed in reference to the contrasting experiences of East Asia and Latin America. This conclusion outlines the main analytical and policy implications of this article, with emphasis on suggesting some ideas for further research.

At the conceptual level, I have claimed along this paper that comparative studies often rely on modelling and measurement strategies that ignores the boundaries between policies and institutions, on the one hand, and between institutions and politics, on the other. Similarly, there is also a tendency to confuse institutions-as-constraints and institutional-outcomes, or, in other words, the structure with the structure-induced equilibrium. This usually leads to analytical stretching, where readers are induced to read too much into the results showing that institutions do matter for development. In this context, the key analytical lesson of this article is that future research on the relationship between institutions and economic performance should be based on a more rigorous distinction between the rules of the game (the matrix of institutions defining the structure of incentives for economic and political exchange), the interests and beliefs of the players (interest groups and key political entrepreneurs) and the way the game is played (the observed behaviour and the set of outcomes induced by a certain institutional configuration). In the same fashion, the good-governance research programme needs to address the problem associated with the lack of analytical differentiation between the political and the institutional embedded in the notion of governance, and between policies and institutions.

In the context of analytical stretching, it is also difficult to read the policy implications of empirical studies. Without an understanding of the independent role of institutions, politics and policies, the critical issue of what is the leverage of governance-

51 Helpman (2004) provides a comprehensive and enlightening guide of what we know, and what we do not know, about the economic and political sources of economic growth.
enhancing institutional reforms remains intractable, let alone the problem of defining what aspects of the institutional structure of a given country should be changed so as to improve outcomes. Let us stress that an institutionally-minded reformer should demonstrate that the design/modification of certain institutional structures has the power to produce better results given an evolving configuration of interests and preferences. Drawing policy lessons is more problematic from a Northean perspective, where the way the game is played (whether actors have incentives to participate in wealth-creating activities) depends on an institutional matrix composed of formal rules, informal constraints and enforcement mechanisms, and on subjective, and often conflicting, mental models which mediate the way economic reality and institutional incentives are translated into actual choices. In this context, the idea of improving the economic performance of a country by simply transplanting or putting in place a set of formal institutions is a recipe for disappointment, not to say disaster (North 2005). This calls for further research oriented to explore the links between formal and informal constraints, the sources of imperfect enforcement, the problem of “interdependent institutions” (North 2005: 157), and the impact of belief systems and learning on both institutional development and economic change.

Demonstrating that growth requires the existence of high-quality institutions is of little help if that proposition is not followed by an analysis of how such good institutions are likely to emerge and become self-enforcing. This brings us to the problem of endogenous institutions. It is widely accepted that our knowledge about how institutions rise, evolve and change is still insufficient (Mantzavinos 2001; Weingast 2002). As a result, the good-governance approach to development operates in the context of a limited understanding of how politics and social processes mediate the relationship between formal institutions and outcomes. Similarly, the field lacks the proper analytical tools for formulating working principles of institutional policy and anticipating the likely unintended consequences of particular reforms. It is not surprising then to see that, despite the growing awareness that good governance matters for development, there has been little evidence of any improvement in global averages of governance in the last decade (Kaufmann et al. 2005). Therefore, more research on the politics of institutional change is in order. As suggested above, the question of how special interests (including the behaviour of international conglomerates) and evolving mental models constraint the degrees of freedom in institutional reform is likely to be a major area of future political economy research.

The analysis of the comparative experiences of East Asia and Latin America has offered interesting insights. First, it has shown that the debate about the relative significance of policy choices and institutional constraints deserves further scrutiny. Second, the analysis has stressed the importance of looking beyond property-rights institutions. The case of East Asia illustrates that indeed a wide range of institutional mechanisms may support sustained growth by solving coordination failures, facilitating public-private sector cooperation and articulating distributional struggles. It also shows that the creation of the political conditions for economic growth requires the solution of multiple credible-commitment problems, regarding both accumulation and distribution. Third, we have seen that the institutional foundations of the strategy of shared-growth implemented in some East Asian countries became self-enforcing in

52 On this front, it is worth noting that the work of Persson and Tabellini (2003) is likely to reopen the debate on the economic effects of political regimes, electoral rules and forms of government.
the context of specific domestic and geopolitical circumstances. This has taught us that any evaluation of the impact of particular institutions on growth should include an analysis of the international and domestic interactions affecting the political foundations of such institutions. In the same way, any debate about the policy implications of comparative studies should rest on rigorous counterfactual reasoning. Last, but not least, it seems that one of the keys for understanding the divergent development paths of East Asia and Latin America is related to the way income inequality has interacted with institutional development and growth. This theme is likely to attract much academic attention in the next years.

The new comparative literature on the economic effects of governance and institutions is a fertile research programme that seeks to identify the binding political and social constraints on development and propose ways to overcome them (Knack 2003). I would like to state clearly that the critique of the institutional political economy of development presented in this article should not lead us to conclude that the conceptual lenses of institutional theory have no analytical power for coming into grips with the complex relationship between politics, institutions and growth. In the same way, this work should not be taken as an attempt to disqualify further efforts to improve the quality of governance indicators and test the sources and effects of institutions in cross-country regressions. On the contrary, this article has tried to highlight some of the analytical gaps of existing studies with the aim of signalling ways of consolidating a more nuanced and sophisticated literature on the political and institutional foundations of development. At the policy level, the effort was concentrated on reflecting about some critical issues that lie beyond the conventional wisdom that good governance is a likely determinant of prosperity.

We can conclude with a methodological point. Helpman (2004: 141) states that “future research has to identify the channels through which institutions affect growth and the ways in which various institutions interact”. However, we should bear in mind that, as highlighted by Bardhan (2005), macro cross-national studies are not always fitted for giving good insights into the mechanisms and processes of development and underdevelopment. This creates a demand for theory-driven, empirically grounded and policy-relevant small-N studies looking at the interaction between politics, institutions and growth in particular countries. As shown above, the context-specific analysis of institutions is essential for understanding the sources of credible commitment and self-enforcing institutions. Future empirical research on governance and development should build on the gains in terms of hypothesis-testing and measurement already made by the econometric-based political economy of growth. In addition, cross-country studies should incorporate the insights offered by the context-specific analytical narratives of economic growth. This dialogue may lead to further developments in terms of the conceptualisation and measurement. Ideally, this research programme should put more emphasis on integrating economic, political and international political economy research. At the end of the day, the only recipe for making progress in solving the puzzles of institutional development and growth lies in a fruitful conversation between theory and empirics, and between economists and political scientists.

53 Rueschemeyer (2003) and George and Bennett (2005) show that much can be learned analytically from well-designed small-N research studies. Rodrik (2003) is a healthy development in this direction. 54 Context-specific analysis is also essential because processes of institutional formation often have multiple equilibria (Bates et al. 1998; Helpman 2004).
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