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

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This article reviews comparative research on institutions and economic performance, identifying analytical gaps in the political economy of growth literature. It also examines core assumptions underpinning the good-governance approach to development. Contrasting experiences of conceptual and policy issues in East Asia and Latin America are discussed. The author suggests future scholarship in this field should distinguish between the rules and the play of the game; move beyond the property rights approach to development; stress the distributional, endogenous nature of institutions; investigate the role of informal constraints and human learning; and consider sources of credible commitment and self-enforcing growth. Focusing on some uncertainties in the accepted wisdom on good governance and development, this article furthers the consolidation of research on the political foundations of 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*, p. xi

A growing literature stresses that governance, broadly defined as the traditions and institutions that determine how authority is exercised in a country, matters to economic development.[1] Building on the influential ideas of Douglass North and Mancur Olson, several cross-national studies have found a positive relationship between the quality of institutions and growth.[2]

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[1] Daniel Kaufmann, Aart Kraay and Pablo Zoido-Lobaton, 'Governance Matters: From Measurement to Action', *Finance & Development*, 37 (2000), 1–6, available at http://www.imf.org/external/pubs/ft/fandd/2000/06/kauf.htm.

[2] See, e.g., Stephen Knack and Philip Keefer, 'Institutions and Economic Performance: Cross Country Tests Using Alternative Institutional Measures', *Economics and Politics*, 7 (1995), 207–27; Paulo Mauro, 'Corruption and Growth', *Quarterly Journal of Economics*, 110 (1995), 681–712; Christopher Clague, *Institutions and Economic Development* (Baltimore, Md.: John Hopkins University Press, 1997); Alberto Alesina, 'The Political Economy of High and Low Growth', in World Bank, *Annual World Bank Conference on Development Economics 1997* (Washington, D.C.: IBRD, 1998), pp. 217–37; Rafael La Porta,

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In this context, a broad consensus among growth economists, development experts and aid donors views 'good governance' as a pre-requisite for sustained increases in living standards.[3] Although this literature has made important advances in uncovering the political, institutional and social determinants of development, the new political economy of growth is not without problems. Econometric works showing that institutions are the key determinant of economic performance have been challenged on the grounds of conceptual vagueness,[4] causality/endogeneity problems,[5] missing-variable considerations,[6] measurement errors,[7] and modelling and specification limitations.[8] Most decisively, the new political economy of growth still lacks a proper grasp of (1) the channels through which institutions affect growth, and (2) the political sources of good institutions.[9] As one observer put it, 'one of the most difficult issues in the field of governance is the imperfect understanding of how politics shapes governance and developmental outcomes'.[10]

Do institutions really cause long-term growth? Should developing countries prioritize governance-enhancing reforms to foster economic development? Unveiling 'the mystery of economic growth' is one of the oldest and most important issues in political economy. It is far beyond the scope of this article to solve the puzzle that has captured the imagination of political economists since the days of Adam Smith.[11] However, this article provides a critical survey of the flourishing comparative literature on the political economy of growth. In particular, I seek to identify the conceptual problems associated with the accepted wisdom that attributes variation in national economic performance to institutions. By doing so, I will also put into question some of the assumptions underpinning the increasingly dominant good-governance approach to development. I will use

(F'note continued)

Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, 'The Quality of Government', *Journal of Law, Economics and Organisation*, 15 (1998), 222–79; Bruce Bueno de Mesquita and Hilton Root, eds, *Governing for Prosperity* (New Haven, Conn.: Yale University Press, 2000); Stephen Knack, *Democracy, Governance, & Growth* (Ann Arbor: University of Michigan Press, 2003); Yi Feng, *Democracy, Governance and Economic Performance* (Cambridge, Mass.: MIT Press, 2003).

[3] Knack, *Democracy, Governance, & Growth,* p. 1.

[4] Thomas G. Weiss, 'Governance, Good Governance and Global Governance: Conceptual and Actual Challenges', *Third World Quarterly*, 21 (2000), 795–814.

[5] Alberto Chong and Cesar Calderon, 'On the Causality and Feedback between Institutional Measures and Economic Growth', *Economics and Politics*, 12 (2000), 69–81; Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Do Institutions Cause Growth?' *Journal of Economic Growth*, 9 (2004), 271–303; Adam Przeworski, 'The Last Instance: Are Institutions the Primary Cause of Economic Development?' *European Journal of Sociology*, 45 (2004), 165–88.

[6] Pranab Bardhan, *Scarcity, Conflicts, and Cooperation: Essays in the Political and Institutional Economics of Development* (Cambridge, Mass.: MIT Press, 2005).

[7] Glaeser *et al*., 'Do Institutions Cause Growth?' Marcus J. Kurtz and Andrew Schrank, 'Growth and Governance: Models, Measures, and Mechanisms', *Journal of Politics*, 69 (2007), 538–54.

[8] Steven N. Durlauf, Paul A. Johnson and Jonathan R.W. Temple, 'Growth Econometrics', in Philippe Aghion and Steven Durlauf, eds, *Handbook of Economic Growth: Volume 1A* (New York: Elsevier North-Holland, 2005), pp. 555–677.

[9] Elhanan Helpman, *The Mystery of Economic Growth* (Cambridge, Mass.: Harvard University Press, 2004).

[10] Daniel Kaufmann, 'Rethinking Governance: Empirical Lessons Challenge Orthodoxy' (World Bank Discussion Paper, 2003), pp. 1–47, at p. 27, available at http://www.worldbank.org/wbi/governance/pdf/rethink_gov_stanford.pdf.

[11] For an insightful analysis of what we know, and what we do not know, about the economic and political sources of economic growth, see Helpman, *The Mystery of Economic Growth*.

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the contrasting experiences of East Asia and Latin America to illustrate the analytical gaps implicit in the quantitative studies of the institutional determinants of prosperity.

This article is organized as follows. First, I review the 'state of the art' in the comparative literature on good governance and economic performance. Secondly, I point out some significant analytical gaps in the new econometric research on institutions and growth. Thirdly, the policy implications of the good-governance approach to development are assessed. Fourthly, I use the contrasting experiences of East Asia and Latin America to underline the major insights of this article. I conclude by outlining the analytical, methodological and policy implications of this article, focusing on providing ideas for further research.

INSTITUTIONS AND ECONOMIC PERFORMANCE: 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*, p. 525.

'The study of economic growth occupies a position that is notably uneasy. Understanding the wealth of nations is one of the oldest and most important research agendas in the entire discipline. At the same time, it is also one of the areas in which genuine progress seems hardest to achieve.'
Durlauf, Johnson and Temple, 'Growth Econometrics', p. 558.

Research on the empirical determinants of economic growth has exploded in the last decades. Indeed, hundreds of international studies have been undertaken to approach the ever-important but elusive question of what causes growth and the prosperity of nations.[12] 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.[13] However, it has been increasingly recognized that politics and institutions are central to the process of economic growth because they affect 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. This section discusses one of the most fertile research streams in the political economy of growth: the literature on institutions, property rights and economic performance.[14]

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: (1) the conflict school, arguing that democracy hinders economic growth, mainly in less developed countries, by creating consumption pressures, fuelling distributional conflicts and inhibiting capital accumulation; (2) the compatibility school, contending that democracy enhances economic growth, because the existence of fundamental civil liberties and political rights generates the social conditions most conducive to economic development; and (3) the sceptical school,

[12] For comprehensive reviews of this vast literature, see Robert J. Barro and Xavier Sala-i-Martin, *Economic Growth* (New York: McGraw-Hill, 1995); Robert J. Barro, *Determinants of Economic Growth* (Cambridge, Mass.: The MIT Press, 1998); Aghion and Durlauf, *Handbook of Economic Growth*.

[13] Helpman, *The Mystery of Economic Growth*.

[14] For a thorough review of the new political economy of growth, see Allan Drazen, *Political Economy in Macroeconomics* (Princeton, N.J.: Princeton University Press, 2000), pp. 457–525.

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claiming that there is no systematic relationship between democracy and economic development.[15] Typically, the advocates of the conflict school used the experiences of countries such as South Korea, Taiwan and Chile as evidence that 'good-for-growth dictatorships' can create the right conditions for growth by providing the sources of political order and social control. However, this argument seems to find little support in global statistical studies. For example, Przeworski, Alvarez, Cheibub and Limongi examine the experiences of 135 countries from 1950 to 1990 and conclude that 'there is no trade-off between democracy and development, not even in poor countries'.[16]

Although Przeworski *et al.* show, quite compellingly, that there is no evidence to support the claim that democracy needs to be sacrificed in the name of economic development, the empirical evidence on the relationship between political regimes and economic growth is still ambiguous. In a comprehensive review of the literature, Yi Feng 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.[17]

Having acknowledged that political regimes were not a key source of variation in observed growth rates, political economists began to investigate the economic effects of institutions and governance structures.[18]

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'. The key contribution of these articles is that they develop novel measures of institutions and property rights, signalling the beginning of a new generation of econometric research on institutions and economic performance in an cross-national setting.[19] In contrast to the literature on political regimes and growth, the claim that 'institutions do

[15] Feng, *Democracy, Governance and Economic Performance*.

[16] Adam Przeworski, Michael E. Alvarez, José Antonio Cheibub and Fernando Limongi, *Democracy and Development: Political Institutions and Well-Being in the World, 1950–1990* (Cambridge: Cambridge University Press, 2000), p. 178.

[17] Feng, *Democracy, Governance and Economic Performance,* pp. 320–1 (emphasis added). On these ambiguous results, see also L. Sirowy and A. Inkeles, 'The Effects of Democracy on Economic Growth and Inequality: A Review', *Studies in Comparative International Development*, 25 (1990), 126–57; Adam Przeworski and Fernando Limongi, 'Political Regimes and Economic Growth', *Journal of Economic Perspectives*, 7 (1993), 51–70; Jan-Erik Lane and Svante Ersson, *Democracy: A Comparative Approach* (New York: Routledge, 2003).

[18] Another research stream has looked at the 'indirect' effect of democracy on growth. In particular, there is evidence that democracy contributes to growth through better income distribution and improvements in public health and education. See, e.g., Feng, *Democracy, Governance and Economic Performance*; Matthew A. Baum and David A. Lake, 'The Political Economy of Growth: Democracy and Human Capital', *American Journal of Political Science*, 47 (2003), 333–47; David S. Brown and Wendy Hunter, 'Democracy and Human Capital Formation: Education Spending in Latin America', *Comparative Political Studies*, 37 (2004), 842–64.

[19] Earlier attempts to test the impact of property rights on growth in international regressions include: Roger C. Kormendi and Philip G. Meguire, 'Macroeconomic Determinants of Growth', *Journal of Monetary Economics*, 16 (1985), 141–63; Kevin B. Grier and Gordon Tullock, 'An Empirical Analysis of Cross-National Economic Growth, 1951–80', *Journal of Monetary Economics*, 24 (1989), 259–76; Gerald

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matter' has received strong empirical support. Building on data for up to ninety-seven countries for the period 1974–89, Knack and Keefer find that the quality of institutions, operationalized as the security of property rights and the level of contract enforcement, is crucial to growth and investment.[20] Similarly, Mauro shows that subjective indexes of corruption are negatively linked with investment and economic growth.[21] In line with these results, Alesina 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.[22] In the last decade, a large number of studies have provided empirical support for the proposition that institutions are a fundamental source of differences in economic development.[23]

Unquestionably, this literature represented a breakthrough in the business of modelling and measuring institutions in the context of cross-country growth regressions. As far as analytical implications are concerned, its findings seem to provide empirical support for the ideas of North and Olson, who stress the role of secure property rights and effective contract enforcement in creating the political conditions for growth and prosperity. Moreover, the discovery of a link between institutions and growth appears to address some of the anomalies of old and new growth theories, which have not been able to accommodate easily the following stylized facts: (1) the absence of general convergence, and (2) why the most rapid growth tends to occur in a subset of low-income countries.[24] The new conventional wisdom is that institutions are the primary cause of economic development. Thus, the name of the game is now convergence, conditional on good institutions. However, how robust are the conceptual and empirical foundations of the institutions–growth causal linkage?

Per capita income and the quality of governance are strongly positively correlated across countries.[25] Although most of the above-mentioned papers used several methods to minimize reverse causation problems, causality is always an issue in growth regressions.[26] For example,

(F'note continued)

W. Scully, 'The Institutional Framework and Economic Development', *Journal of Political Economy*, 96 (1988), 652–62.

[20] Knack and Keefer, 'Institutions and Economic Performance'.

[21] Mauro, 'Corruption and Growth'.

[22] Alesina, 'The Political Economy of High and Low Growth'.

[23] See, e.g., La Porta *et al.*, 'The Quality of Government'; Robert E. Hall and Charles I. Jones, 'Why Do Some Countries Produce So Much More Output per Worker than Others?' *Quarterly Journal of Economics*, 114 (1999), 83–116; Daron Acemoglu, Simon Johnson and James A. Robinson, 'The Colonial Origins of Comparative Development', *American Economic Review*, 91 (2001), 1369–401; Daron Acemoglu, Simon Johnson and James A. Robinson, 'Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution', *Quarterly Journal of Economics*, 117 (2002), 1231–94; William Easterly and Ross Levine, 'Tropics, Germs, and Crops: How Endowments Influence Economic Development', *Journal of Monetary Economics*, 50 (2003), 3–39; Dani Rodrik, Arvind Subramanian and Francesco Trebbi, 'Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development', *Journal of Economic Growth*, 9 (2004), 131–65. For a review of this literature, see Daron Acemoglu, Simon Johnson and James A. Robinson, 'Institutions as the Fundamental Cause of Long-Run Growth', in Aghion and Durlauf, *Handbook of Economic Growth,* pp. 385–472.

[24] Mancur Olson, 'Big Bills Left on the Sidewalk: Why Some Nations Are Rich and Others Poor', *Journal of Economic Perspectives*, 10 (1996), 3–24. See also Knack, *Democracy, Governance, & Growth.*

[25] Daniel Kaufmann and Aart Kraay, 'Growth without Governance', *Economia: The Journal of the Latin American and Caribbean Economic Association*, 3 (2003), 169–215, p. 169.

[26] Problems may arise not only because causality runs from income to institutions, but also because the institutional variables are measured at the end (or too close to the end) of the growth period.

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Chong and Calderon apply a rigorous approach of causality to measures of institutional quality and economic growth, finding strong evidence of causation running in both directions, from institutions to growth, and from growth to institutional quality.[27] By contrast, building on a new dataset and using non-sample information, Kaufmann and Kraay find no evidence of a positive effect of incomes on the quality of institutions, calling into question the often-heard argument that only wealthy countries can afford good governance.[28] Acemoglu *et al.* claim to capture the causal effect of economic institutions on prosperity by 'instrumenting' the quality of current institutions with original variables measuring the historical conditions in the European colonies.[29] However, Glaeser *et al.* question the validity of these instruments and show that 'the evidence that institutions cause economic growth, as opposed to growth improving institutions, is non-existent'.[30] Not surprisingly, the evidence on causality is inconclusive and the debate remains open.[31]

Omitted variable biases may also explain the strong correlation between good governance and high growth. For example, Sachs shows that geography, reflected in weather conditions and access to maritime trade routes, plays a major role in countries' economic success.[32] Other studies have documented the importance of factor endowments,[33] colonial heritages,[34] legal traditions,[35] ethnic conflicts and social heterogeneity,[36] and religious composition.[37] Most critically, the institutional economics literature has overlooked the role of the state in resolving co-ordination failures and facilitating private–public sector co-operation in early stages of industrialization.[38] The Olsonean problem of

[27] Chong and Calderon, 'On the Causality and Feedback between Institutional Measures and Economic Growth'.

[28] Kaufmann and Kraay, 'Growth without Governance'.

[29] Acemoglu *et al.*, 'The Colonial Origins of Comparative Development'.

[30] Glaeser *et al.*, 'Do Institutions Cause Growth?' p. 285.

[31] A recent paper, using dynamic panel and linear feedback analysis, shows that there is double causality between institutions and inequality. See Alberto Chong and Mark Gradstein, 'Inequality and Institutions', *Review of Economic and Statistics*, 89 (2007), 454–65.

[32] E.g., Jeffrey D. Sachs, 'Tropical Underdevelopment', *NBER Working Paper No. 8119* (Cambridge, Mass.: National Bureau of Economic Research, 2001).

[33] E.g., Kenneth L. Sokoloff and Stanley L. Engerman, 'History Lessons: Institutions, Factor Endowments, Institutions, and Paths of Development in the New World', *Journal of Economic Perspectives*, 14 (2000), 217–32.

[34] E.g., Hall and Jones, 'Why Do Some Countries Produce So Much More Output per Worker than Others?' Douglass C. North, William Summerhill and Barry R. Weingast, 'Order, Disorder, and Economic Change: Latin America versus North America', in Bueno de Mesquita and Root, eds, *Governing for Prosperity*, pp. 17–58.

[35] E.g., La Porta *et al.*, 'The Quality of Government'; Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'Courts', *Quarterly Journal of Economics*, 118 (2003), 453–517.

[36] E.g., William Easterly and Ross Levine, 'Africa's Growth Tragedy: Policies and Ethnic Divisions', *Quarterly Journal of Economics*, 111 (1997), 1203–50; Philip Keefer and Stephen Knack, 'Polarization, Politics and Property Rights', *Public Choice*, 111 (2002), 127–54; Alberto Alesina, Arnaud Devleeschauwer, William Easterly and Romain Wacziarg, 'Fractionalization', *Journal of Economic Growth*, 8 (2003), 155–94.

[37] E.g., La Porta *et al.*, 'The Quality of Government'.

[38] Bardhan, *Scarcity, Conflicts, and Cooperation,* pp. 7–19; Robert H. Bates, 'The Role of the State in Development', in Barry R. Weingast and Donald Wittman, eds, *The Oxford Handbook of Political Economy* (Oxford: Oxford University Press, 2006), pp. 708–22; Mick Moore, 'Revenues, State Formation, and the Quality of Governance in Developing Countries', *International Political Science Review*, 25 (2004), 297–319. On the role of the state in East Asia, see also Alice Amsden, *Asia's Next Giant: South*

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how interest-group formation intersects with institutions in affecting economic growth is also missing in most analyses of the institutional sources of development.[39]

In various studies, Acemoglu, Johnson and Robinson (AJR) claim that once one controls properly for the effects of economic institutions, neither geography, nor the identity of the colonial power, nor the ethnic and religious composition of the population, nor religion, are deeper determinants of income per capita.[40] However, AJR also recognize that the very institutions that are central in determining relative prosperity are endogenous, and that 'a theory of why different countries have different economic institutions must be based on politics, on the structure of political power, and the nature of political institutions'.[41] In this vein, Helpman argues that AJR indeed demonstrate 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'.[42] In this context, there are two problems with the 'primacy of institutions' thesis. The first is that the combination of the two central tenets of new institutionalism ('institutions matter' and 'institutions are endogenous') leads to circularity. As Przeworski clearly put it, if the endogeneity of institutions is sufficiently strong 'then institutions have no autonomous role to play. Conditions shape institutions and institutions only transmit the causal effects of these conditions'.[43] The second potential problem is conceptual stretching. The institutions-rule literature 'tends to see institutions everywhere', thus downplaying the critical importance of developments at the level of 'society-rooted politics'.[44]

Critically, remaining problems in terms of conceptualization and measurement also call into question the conventional wisdom on good governance and development. Like the concept of democracy, governance, and by implication good governance, is an 'essentially

(F'note continued)

Korea and Late Industrialization (Oxford: Oxford University Press, 1989); Robert Wade, *Governing the Market* (Princeton, N.J.: Princeton University Press, 1990); Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton, N.J.: Princeton University Press, 1995). For large-*N* studies on the effects of state structures, see Peter Evans and James Rauch, 'Bureaucracy and Growth: A Cross-National Analysis of the Effects of Weberian State Structures on Economic Growth', *American Economic Review*, 64 (1999), 748–65; James Rauch and Peter Evans, 'Bureaucratic Structure and Economic Performance in Less Developed Countries', *Journal of Public Economics*, 75 (2000), 49–71. For a recent effort to bring the state back into the discussion, see Matthew Lange and Dietrich Rueschemeyer, eds, *States and Development* (Basingstoke, Hants.: Palgrave Macmillan, 2005).

[39] Helpman, *The Mystery of Economic Growth*, pp. 136–8.

[40] Acemoglu *et al*., 'The Colonial Origins of Comparative Development'. See also Easterly and Levine, 'Tropics, Germs, and Crops'; Rodrik *et al*. 'Institutions Rule'.

[41] Acemoglu *et al*., 'Institutions as the Fundamental Cause of Long-Run Growth', p. 463.

[42] Helpman, *The Mystery of Economic Growth,* p. 125.

[43] Przeworski, 'The Last Instance', p. 166.

[44] S. N. Sangmpam, 'Politics Rules: The False Primacy of Institutions in Developing Countries', *Political Studies*, 55 (2007), 205–7. Uncertainties remain even within the 'institutions rule' consensus. For example, in a review article Rodrik qualifies the strong institutionalist flavour of Rodrik *et al*.'s 'Institutions Rule', suggesting that that work should not be seen in the frontline of institutions fundamentalism (see Dani Rodrik, 'Goodbye Washington Consensus, Hello Washington Confusion?' *Journal of Economic Literature,* 44 (2006), 973–87, p. 979). Similarly, Robinson, one of the co-authors of AJR, says that the Latin American equilibrium of poor institutions is deeply rooted in a given distribution of political power (see James A. Robinson, 'El Equilibrio de America Latina', in Francis Fukuyama, ed., *La Brecha entre America Latina y Estados Unidos: Determinantes politicos e institucionales del desarrollo economico* (Buenos Aires: Fondo de Cultura Economica, 2006), pp. 197–230).

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contested' concept.[45] However, though there is an established literature dedicated to assessing the validity of alternative ways of conceptualizing and measuring democracy,[46] the discussion of the analytics and methods of good governance is still underdeveloped.[47] On the empirical front, Mauro and also Knack and Keefer revolutionized the art of measuring institutions by introducing the use of subjective indicators of corruption, governments' repudiation of contracts and bureaucratic efficiency produced by private risk assessment agencies.[48] However, the indicators used to establish the proposition that institutions cause growth are constructed to be conceptually unsuitable for that purpose.[49] North defines institutions as the 'humanly devised *constraints* that shape human interaction'.[50] However, most perception-based measures of institutional quality are not measuring institutions as constraints, but institutional outcomes/performance. Glaeser *et al*. show that widely-used governance indicators are (1) too volatile to reflect more or less permanent features of the political environment and (2) tend to rise with per capita income.[51] In their critique of the World Bank Governance Indicators, Kurtz and Schrank

[45] Todd Landman and Julia Häusermann, 'Map-Making and Analysis of the Main International Initiatives on Developing Indicators on Democracy and Good Governance' (unpublished paper, Human Rights Centre, University of Essex, 2003).

[46] See, e.g., Alex Inkeles, *On Measuring Democracy: Its Consequences and Concomitants* (Brunswick, N.J.: Transaction Publishers, 1991); Joe Foweraker and Roman Krznaric, 'Measuring Liberal Democratic Performance', *Political Studies,* 47 (2000), 759–87; Gerardo L. Munck and Jay Verkuilen, 'Conceptualizing and Measuring Democracy: Evaluating Alternative Indices', *Comparative Political Studies*, 35 (2002), 5–34; Robert A. Dahl, Ian Shapiro and José Antonio Cheibub, eds, *The Democracy Sourcebook* (Cambridge, Mass.: MIT Press, 2003); Kirk Bowman, Fabrice Lehouck and James Mahoney, 'Measuring Political Democracy: Case Expertise, Data Adequacy and Central America', *Comparative Political Studies*, 38 (2005), 939–70.

[47] For interesting developments in this area, see Weiss, 'Governance, Good Governance and Global Governance'; Landman and Häusermann, 'Map-Making and Analysis of the Main International Initiatives on Developing Indicators on Democracy and Good Governance'; Knack, *Democracy, Governance, & Growth*; Christopher Woodruff, 'Measuring Institutions', in Susan Rose-Ackerman and Henry Luce, eds, *International Handbook on the Economics of Corruption* (Northampton: Edward Elgar, 2006); Christiane Arndt and Charles Oman, *Uses and Abuses of Governance Indicators* (Paris: OECD Development Centre Studies, 2006); and the insightful exchange between Kurtz and Schrank, 'Growth and Governance', and Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, 'Growth and Governance: A Reply', *Journal of Politics*, 69 (2007), 555–62.

[48] Knack and Keefer, 'Institutions and Economic Performance'; Mauro, 'Corruption and Growth'. The first generation of empirical studies on institutions and growth measured countries' institutional environment through Gastil indices (e.g., Kormendi and Meguire, 'Macroeconomic Determinants of Growth'; Grier and Tullock, 'An Empirical Analysis of Cross-National Economic Growth'; Scully, 'The Institutional Framework and Economic Development') or objective counts of political violence (e.g., Robert J. Barro, 'Economic Growth in a Cross Section of Countries', *Quarterly Journal of Economics*, 106 (1991), 407–43; Alberto Alesina, Sule Ozler, Nouriel Roubini and Phillip Swagel, 'Political Instability and Economic Growth', *Journal of Economic Growth*, 1 (1996), 189–211). However, those measures delivered questionable proxies of concepts such as the rule of law, contract enforceability and the security of property rights. See Stephen Knack, 'Governance and Growth: Measurement and Evidence' (paper presented at the Forum on the Role of Institutions in Promoting Growth, IRIS Center and USAID, Washington, D.C., 2002).

[49] Glaeser *et al*., 'Do Institutions Cause Growth?' p. 271.

[50] Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990), p. 3.

[51] At the conceptual level, these authors claim 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'. See Glaeser *et al*., 'Do Institutions Cause Growth?' p. 271.

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argue that the dominant measures of governance suffer from perceptual biases, adverse selection in sampling and conceptual conflation with policy choices.[52]

Many empirical studies suggest that institutions do matter for economic performance. However, I have shown in this section that the proposition that good governance *causes* economic development can be contested on conceptual and methodological grounds. The econometrics of institutions and growth is still haunted by causality uncertainties, omitted variable biases, modelling/specification deficiencies, and most importantly, by problems of conceptualization and measurement. This should lead to serious concern about the empirical foundations of the prevailing 'governance matters' consensus. It may also lead to scepticism about the power of large-*N* cross-national studies in offering insights into the institutional foundations of economic development.[53] However, I believe that, whatever the remaining empirical problems, the main deficit of this research programme is analytical. Specifically, it relates to our imperfect understanding of how politics interacts with institutions in shaping development policies and outcomes. As Helpman and North highlight, we lack a developed body of theory capable of linking polities, institutional change and economic performance.[54] In the next section, I will discuss the analytical gaps in the comparative literature on institutions and development.

ANALYTICAL GAPS IN THE COMPARATIVE LITERATURE

'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*, p. ix (emphasis added)

In principle, the literature on institutions and growth can be criticized from two different analytical positions. On the one hand, one can question the validity of the governance-causes-growth consensus by challenging the core assumptions of new institutionalism. On the other hand, one can discuss the analytical problems of the literature by seeking further integration between growth empirics, institutional theory and political economy. In this section, I adopt the second strategy. I identify the analytical lacunae of existing empirical research by drawing lessons from leading scholars working in the political economy of institutions research tradition.

Conflation of Policies and Institutions

One of the central tenets of new institutionalism is the existence of a qualitative distinction between policies and institutions. Institutions are conceptualized as enduring entities that do not change easily at the will of the agents.[55] As Tsebelis put it, the expected life of institutions

[52] Kurtz and Schrank, 'Growth and Governance', p. 538. For a defence of the World Bank Governance Indicators, see Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi, 'Measuring Governance Using Cross-Country Perceptions Data', in Rose-Ackerman and Luce, eds, *International Handbook on the Economics of Corruption*; Daniel Kaufmann and Aart Kraay, 'Governance Indicators: Where Are We, Where Should We Be Going?' *World Bank Research Observer*, 23 (2008), 1–30.

[53] Bardhan, *Scarcity, Conflicts, and Cooperation*.

[54] Helpman, *The Mystery of Economic Growth*; Douglass C. North, *Understanding the Process of Economic Change* (Princeton, N.J.: Princeton University Press, 2005).

[55] Bo Rothstein, 'Political Institutions: An Overview', in Robert E. Goodin and Hans-Dieter Klingemann, eds, *A New Handbook of Political Science* (Oxford: Oxford University Press, 1996), pp. 133–66, at p. 152.

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(constraints) is much higher than the expected life of policies.[56] The implication is that policies are chosen in the context of institutions. The existence of alternative institutional arrangements facilitates/complicates the negotiation/implementation of alternative policies through the definition of the structure of incentives and transaction costs. In short, new institutionalism stresses the importance of drawing a clear analytical line between rules and policies, and between 'choices given the rules' and 'choices about the rules'.[57]

The distinction between policies and institutions is too often overlooked in the good governance literature. Olson's main arguments in his seminal paper, 'Big Bills Left in the Sidewalk: Why Some Nations are Rich, and Other Poor', are that (1) a 'country's institutions and economic policies are decisive for its economic performance' (theoretical proposition) and (2) 'any poorer countries that adopt relatively good economic policies and institutions enjoy rapid catch-up growth' (normative proposition).[58] There are important conceptual and empirical problems hidden behind these apparently straightforward propositions. To begin with, available good-governance measures tend to conflate institutions and policy choices, making it difficult (if not impossible) to assess the independent economic effect of institutions. In addition, the estimation of growth regressions with policy variables on the right-hand side involves significant methodological hazards.[59] At the conceptual level, the conflation of policies and institutions obscures one of the central debates in development studies, which is precisely about whether governments should prioritize building good institutions or delivering sound policies. Some scholars claim that problems such as inflation, fiscal deficits and economic decline should be tackled through sweeping rule-based institutional reforms. Others defend the view that good economic outcomes are achieved if sound fiscal, monetary and development *policies* are incrementally implemented. We will see below that the 'institutions versus policies' debate is at the heart of alternative interpretations of the East Asian miracle.

Analytical Stretching: Too Much Institutionalism, Too Little Politics

There is also a tendency to read too 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'.[60] I asserted elsewhere that an institutionalist approach is useful for understanding the political economy of this country.[61] I would like to stress here that the Argentine case is also useful for highlighting the limitations of narrow institutionalism. Argentina was one of the slowest-growing countries in the period 1960–90, a performance clearly accompanied by bad governance.[62] However, to claim that poor institutional quality – reflected in bureaucratic inefficiency, corruption and insecure property rights – is the key variable explaining the collapse of Argentina's growth implies stretching the analytical reach of the institutionalist approach. Actually, both institutional decay and stagnation were embedded in deeply rooted politico-economic

[56] George Tsebelis, *Nested Games: Rational Choice in Comparative Politics* (San Francisco: University of California Press, 1990), p. 98.

[57] Geoffrey Brennan and James M. Buchanan, *The Reason of Rules: Constitutional Political Economy* (Cambridge: Cambridge University Press, 1985).

[58] Olson, 'Big Bills Left on the Sidewalk', p. 21.

[59] See Rodrik *et al.*, 'Institutions Rule'.

[60] Gerardo della Paolera and Alan M. Taylor, eds, *A New Economic History of Argentina* (Cambridge: Cambridge University Press, 2003), p. 3.

[61] Sebastian Dellepiane-Avellaneda, 'The Political Economy of Institutional Credible Commitments: The Case of Argentina's Convertibility Law, 1991–2001' (doctoral dissertation, University of Essex, 2005).

[62] Alesina, 'The Political Economy of High and Low Growth'.

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disequilibria. Politics, and not institutions, was the key factor driving Argentina's economic underperformance. For example, some authors show 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'.[63] Clearly, politico-economic disequilibria had institutional manifestations. Mallon and Sourrouille stress that in Argentina 'accepted 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'.[64] The problem is, however, that too often the concept of institutions becomes a proxy for 'politics and society' (or of 'society-rooted political conflicts/struggles' using Sangmpam's language),[65] losing its analytical value.

Analytical stretching is also the rule in the comparative literature. For example, Feng uses the template of the political economy of growth to account for the economic performance of Pacific Asian countries.[66] His central argument is that 'political institutions' have a pronounced effect on growth. At first glance, such a claim has a strong institutionalist flavour. Yet a closer look at this work unveils a more nuanced scenario. 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 also finds that political institutions (operationalized in terms of political repression, political instability and policy uncertainty) do affect economic growth by constraining individuals' decisions in the marketplace. This general proposition appears highly plausible.[67] However, Feng's work might be capturing the political context of economic development, rather than its institutional foundations. Indeed, the standard modelling/measurement strategies used in the political economy of growth are designed to gauge the way politics, broadly defined, affects the domestic 'business environment'. Further research oriented to disentangling the sources of growth should rest upon a proper discrimination between the political and the institutional embedded in the concepts of 'governance' and 'political institutions'.[68]

The Core of the Argument: 'Structure' and 'Structure-induced Equilibrium'

Neo-institutionalist scholars discriminate between the 'rules of the game' and the strategies and beliefs of the 'players of the game'.[69] Critically, they also distinguish the 'structure' (the institutions specifying the set of players, the permissible moves, the informational conditions, etc.) from the 'structure-induced equilibrium' (the equilibrium in outcomes induced by a given institutional configuration).[70] The problem is that concepts

[63] Guido Di Tella and Rudiger Dornbusch, eds, *The Political Economy of Argentina, 1946–83* (Basingstoke, Hants.: Macmillan, 1989), p. 7.

[64] Richard Mallon and Juan Sourrouille, *Economic Policymaking in a Conflict Society: The Argentine Case* (Cambridge, Mass.: Harvard University Press, 1975), p. 154.

[65] Sangmpam, 'Politics Rules'.

[66] Yi Feng, 'Political Institutions, Economic Growth, and Democratic Evolution: The Pacific Asian Scenario', in Bueno de Mesquita and Root, eds, *Governing for Prosperity*, pp. 172–208.

[67] Feng, *Democracy, Governance and Economic Performance*.

[68] For example, Sangmpam in 'Politics Rules' proposes the breaking up of the political system into its three components: politics, institutions and the state itself.

[69] North, *Institutions, Institutional Change and Economic Performance*.

[70] Kenneth A. Shepsle, 'Studying Institutions', *Journal of Theoretical Politics,* 1 (1989), 131–47, p. 138; Kenneth A. Shepsle, 'Old Questions and New Answers about Institutions: The Riker Objection Revisited', in Weingast and Wittman, eds, *The Oxford Handbook of Political Economy,* pp. 1031–49.

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such as political stability and government repression are not institutions-as-constraints, but structure-induced equilibria or institutional outcomes. Using Northean language, they are not referring to the rules of the game, but to the way in which the game is played by certain agents in different arenas. The problem is to identify what are the precise institutional rules (constitutions, electoral rules, economic regulations, social norms) structuring the behaviour of the relevant economic and political players. The question is even more complicated. According to the new institutionalism, institutions are the key variable motivating changes in political behaviour under the assumption that preferences are fixed in the short term.[71] But preferences do vary across countries and space. So indeed both preferences and institutions determine outcomes.[72]

This confusion between the institutional structure, the institutional equilibrium and a simple policy equilibrium is at the core of our discussion.[73] It relates both to the issues of policy/institution conflation and politics/institutions conceptual stretching. Consider the example of taxation in Britain. It can be argued that Britain is in equilibrium at relatively low levels of taxation (at least by European standards). However, is this structure-induced equilibrium? Most importantly, is this pattern a good measure of the quality of fiscal/political institutions in Britain? Institutions may have played a role in shaping the British tax system. However, this low-taxation equilibrium has also been induced by historically formed preferences and ideas, by party competition, by the societal distribution of power and by the global role of the British economy. In this context, inferring the features/causal significance of the rules of the game from the policy equilibrium leads to analytical stretching and severe problems of measurement validity. Institutions are important because they arbitrate the way in which power, preferences and beliefs are translated into policy choices. Yet this does not mean that power, preferences and beliefs are not reflected in equilibrium outcomes. Hence, conceptualizing/measuring institutions through performance/outcomes (e.g. policy credibility, corruption, expropriation), a common practice in the good governance literature, is extremely problematic. For example, a high degree of polarization (a variable often invoked as evidence of bad governance) in a country can be rooted in both institutions and preferences, or simply in the underlying economic/political structures shaping both preferences and institutions.

(Re)learning the Lessons of the 'Northean' Approach to Institutions and Growth

Douglass North is probably the most cited author in the political economy of growth literature. Paradoxically, the full implications of his approach are often overlooked, if not blatantly ignored. North expands in significant ways the analysis of the relationship between institutions and development. First, he claims that the structure defining the set of incentives in a society (the 'institutional matrix') is composed not only of formal rules, but also of informal constraints and enforcement characteristics.[74] Secondly, he argues

[71] William H. Riker, 'Implications from the Disequilibrium of Majority Rule for the Study of Institutions', *American Political Science Review*, 74 (1980), 432–46.

[72] Melvin J. Hinich and Michael C. Munger, *Analytical Politics* (Cambridge: Cambridge University Press, 1997).

[73] Formally, equilibrium is a 'status quo position in the policy space that cannot be defeated by another feasible position' (Hinich and Munger, *Analytical Politics*, p. 52). In this article, equilibrium refers to a 'stable policy outcome'. The latter is equilibrium provided that the main actors involved do not have incentives to change their behaviour given what others are likely to do in response.

[74] North, *Institutions, Institutional Change and Economic Performance*.

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that actors make choices using subjective mental models and thus 'individuals from different backgrounds will interpret the same evidence differently [including the structure of incentives!] and in consequence make different choices'.[75] Last, and clearly not least, North underscores the endogenous and political nature of institutions.[76] In a world of pervasive informal constraints, imperfect enforcement, conflicting beliefs and endogenous rules, conceptualizing (let alone modelling empirically) the relationship between institutions and outcomes is challenging.

One of the main analytical lessons of the Northean approach is that the real incentive structure of an economy is defined both by formal rules and informal constraints. A line of political economy research has sought to unveil the social conditions of development by studying the effects of norms of civic co-operation, interpersonal trust and social capital. For example, Knack and Keefer, using data from World Values Surveys, provide evidence that trust and civic co-operation have a significant impact on aggregate economic activity.[77] Temple and Johnson also demonstrate that 'social capability' is a factor of economic growth.[78] However, despite these efforts, our knowledge about the complex relationship between formal rules and informal constraints is still insufficient, so is 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*'.[79] Econometric studies of the economic effects of enforcement mechanisms are rare, probably due to the obvious difficulties associated with measuring them. Similarly, lack of awareness of 'the centrality of beliefs and learning' continues to be one of the most serious omissions in the scholarship on political economy.[80]

Taking Seriously the Distributional Sources of Institutions and Development

In reviewing the new institutional tradition in comparative politics, Jonas Pontusson recommends researchers to 'put political institutions in their place and take interests seriously'.[81] This advice should be also taken into account by scholars working on the institutional approach to development. We should not forget that institutions are not only means for mitigating collective-action problems, but also 'weapons of coercion and redistribution'.[82] Indeed, the distributional implications of institutions have been repeatedly underlined by neo-institutional scholars of both the rational choice and

[75] North, *Understanding the Process of Economic Change,* p. 62. See also Arthur Denzau and Douglass C. North, 'Shared Mental Models: Ideologies and Institutions', *Kyklos,* 47 (1994), 3–31; Jack Knight and Douglass C. North, 'Explaining Economic Change: The Interplay between Cognition and Institutions', *Legal Theory*, 3 (1997), 211–26.

[76] Douglass C. North, 'Economic Performance through Time', *American Economic Review,* 84 (1994), 359–68.

[77] Stephen Knack and Philip Keefer, 'Does Social Capital Have an Economic Payoff? A Cross-country Empirical Investigation', in Knack, *Democracy, Governance, & Growth,* pp. 252–90.

[78] Jonathan Temple and Paul A. Johnson, 'Social Capability and Economic Growth', *Quarterly Journal of Economics*, 113 (1998), 965–90.

[79] North, *Understanding the Process of Economic Change,* p. 48 (emphasis added).

[80] Douglass C. North, 'What Is Missing from Political Economy', in Weingast and Wittman, *The Oxford Handbook of Political Economy*, pp. 1003–9.

[81] Jonas Pontusson, 'From Comparative Public Policy to Political Economy: Putting Political Institutions in Their Place and Taking Interests Seriously', *Comparative Political Studies*, 28 (1995), 117–47, p. 117.

[82] T. M. Moe, 'Political Institutions: The Neglected Side of the Story', *Journal of Law, Economics, and Organizations,* 6 (1990), 213–53, p. 213.

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historical traditions.[83] Although the theme of how vested interests affect institutional reforms is slowly permeating the good-governance research agenda, this issue clearly deserves more attention.[84] In one of his excellent essays on the political and institutional economics of development, Bardhan claims that further research is needed to uncover the relationship between 'distributive conflicts' and 'the persistence of inefficient institutions'.[85] 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'.[86] The key lesson is that research on the institutional foundations of development needs to incorporate the logic of 'contentious politics' into the dominant 'co-operation politics' narrative.

Moving beyond a Narrow and Naïve Approach to Property Rights

Bardhan also contends that the institutional economics of development should move beyond the narrow focus on the undoubtedly important 'institutions that protect individual property rights'.[87] The bulk of his argument is that a wide range of political and social institutions can correct some of the pervasive co-ordination and co-operation failures involved in the process of moving from underdevelopment to development. The idea that there is more than one institutional path to economic success is consistent with the message of the 'varieties-of-capitalism' literature[88] and with the Northean approach. North emphasizes the importance of private property rights and contract enforcement. However, he also stresses that because institutions simply emerge to provide co-operative solutions to problems, a variety of institutional arrangements may evolve to reduce transaction costs in impersonal exchange. In an infrequently cited paper, North criticizes the privatization processes of Russia and other East European countries (where the enforcement of private property rights did not seem to provide the right incentives), and contrasts them with the evolution of institutions in fast-growing China. On the experience of the latter country, 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.'[89]

[83] See North, *Institutions, Institutional Change and Economic Performance*; Tsebelis, *Nested Games*; Jack Knight, *Institutions and Social Conflict* (Cambridge: Cambridge University Press, 1992); Kathleen Thelen and Sven Steinmo, 'Historical Institutionalism in Comparative Politics', in Sven Steinmo, Kathleen Thelen and Frank Longstreth, eds, *Structuring Politics* (Cambridge: Cambridge University Press, 1992), pp. 1–32; Peter A. Hall, 'The Role of Interests, Institutions, and Ideas in the Comparative Political Economy of Industrialized Nations', in Mark Lichbach and Alan Zuckerman, eds, *Comparative Politics* (Cambridge: Cambridge University Press, 1997), pp. 174–207; Paul Pierson and Theda Skocpol, 'Historical Institutionalism in Contemporary Political Science', in Ira Katznelson and Helen Milner, eds, *Political Science: The State of the Discipline* (New York: Norton, 2002), pp. 693–721.

[84] For a classical account of the distributive politics of development, see Robert H. Bates, 'Macropolitical Economy in the Field of Development', in James Alt and Kenneth Shepsle, eds, *Perspectives on Positive Political Economy* (Cambridge: Cambridge University Press, 1990), pp. 31–54.

[85] Bardhan, *Scarcity, Conflicts, and Cooperation*, p. 27.

[86] Bardhan, *Scarcity, Conflicts, and Cooperation,* p. 30.

[87] Bardhan, *Scarcity, Conflicts, and Cooperation*, p. 2.

[88] Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001). For an application in transition countries, see Magnus Feldmann, 'Emerging Varieties of Capitalism in Transition Countries: Industrial Relations and Wage Bargaining in Estonia and Slovenia', *Comparative Political Studies*, 39 (2006), 829–54.

[89] Douglass C. North, *Understanding the Process of Economic Change* (London: Institute of Economic Affairs, 1999), p. 23.

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The good-governance consensus also rests upon a naïve and a-historical narrative about private property rights. Although it is argued that secure and stable property rights are good for growth, the literature seldom discusses the critical issues of (1) how property rights emerge and evolve in particular countries; (2) the distributional consequences of such an evolution for different social groups; and (3) the level of political legitimacy associated with alternative property structures. In this context, some of the 'unpleasant trade-offs' implicit in the idea of 'protecting property rights' are downplayed. For example, what are the implications of protecting property rights in contemporary Brazil, where there is a historical distributional struggle between overrepresented landowning elites and underrepresented landless peasants? In the same logic, what are the equity implications of enforcing contracts in countries like Argentina, Bolivia and Russia, where pervasive corruption affected the very privatization processes through which those contracts were negotiated? Similarly, history shows that most of today's rich countries developed in the context of a restricted and selective protection of property rights.[90] Therefore, the good-governance literature has to accommodate the 'disturbing' fact that both the establishment and protection of property rights are not mere technical issues of state capacity, but intensely political processes.

The Role of Credible Commitments and Self-enforcing Institutions

Credible commitment is the most pressing issue for developing countries.[91] The problem of credible commitment is the fundamental political dilemma of an economy: 'a government strong enough to protect property rights is also strong enough to confiscate the wealth of its citizens'.[92] Given this Hobbesian dilemma, governments need to make credible commitments to provide the political sources of economic growth, including protecting property rights. The problem is that, in the absence of specific conditions, 'pro-growth politics' does not produce equilibrium. Indeed, throughout history the presence of such conditions has been the exception rather than the rule. In this context, political economists have shown that governments may create incentives for keeping promises through time by adopting 'pre-commitment strategies', which often involve the building of institutions.[93] In order to establish a wealth-creating game, the argument goes, 'a government must provide the appropriate formal institutions and credibly commit to them'.[94]

Unfortunately, the literature on credible commitment is also informed by a narrow property-rights perspective focusing on the transactions between rulers, asset holders and investors. Yet the creation of the political conditions for growth requires the solution of

[90] See, for example, Stephen Haber, Armando Razo and Noel Maurer, *The Politics of Property Rights: Political Instability, Credible Commitments, and Economic Growth in Mexico, 1876–1929* (Cambridge: Cambridge University Press, 2003).

[91] Douglass C. North, 'Institutions and Credible Commitment', *Journal of Institutional and Theoretical Economics,* 149 (1993), 11–23, p. 11.

[92] Barry R. Weingast, 'The Economic Role of Political Institutions: Market-preserving Federalism and Economic Development', *Journal of Law, Economics, and Organization*, 11 (1995), 1–31, p. 1.

[93] See Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985); Kenneth A. Shepsle, 'Discretion, Institutions and the Problem of Government Commitment', in Pierre Bourdieu and James Coleman, eds, *Social Theory for a Changing Society* (Boulder, Colo.: Western Press, 1991), pp. 245–63; Douglass C. North and Barry R. Weingast, 'Constitutions and Commitments', *Journal of Economic History*, 19 (1989), 803–32; Brian Levy and Pablo T. Spiller, 'The Institutional Foundations of Regulatory Commitment', *Journal of Law, Economics and Organisation*, 10 (1996), 201–46.

[94] C. Mantzavinos, *Individuals, Institutions, and Markets* (Cambridge: Cambridge University Press, 2001), p. 245.

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multiple credible-commitment problems. Take the example of East Asia. Campos and Root show that the key to the Asian miracle was the way in which governments made credible the so-called 'shared-growth' strategy.[95] On the one hand, East Asian leaders won the co-operation of the economic elites for the implementation of growth-enhancing policies by establishing 'institutions, rules, and procedures that limited government discretion over economic policy'.[96] On the other hand, governments introduced sweeping 'wealth-sharing mechanisms' aimed at signalling to the non-elite populace that they would share the benefits of economic growth. Multiple credible commitments are even more relevant to reconciling economic growth and democratic governance. Boix demonstrates that a self-enforcing democratic equilibrium depends on whether the wealthy elites can make credible commitments towards free and fair elections, and the poor towards moderate levels of redistribution.[97] Similarly, Weingast shows that one of the factors explaining ethnic conflict, an outcome undermining both democratization and economic development, is the impossibility of actors' sustaining credible commitments towards protecting minority rights.[98] This underlines the importance of integrating the 'politics of accumulation' and 'the politics of redistribution' in the study of institutional credible commitments.

Institutions Are Endogenous

Institutions-based explanations cannot easily reconcile the 'institutions rule' claim with the endogenous nature of institutions.[99] Empirical studies have generally 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.[100] Therefore, the challenge is 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).[101]

The conventional approach has been to divide the study of institutions into two levels of analysis: (1) a very active research programme looking at the question of 'institutional effects', and (2) a far less developed line of inquiry dealing with the theory of endogenous institutions. The dominance of the former approach is the consequence of the intrinsic complexity of 'modelling games with variable rules',[102] but also of the assumption that explaining the origins and survival of institutions should be based on a prior knowledge of their effects.[103] In my opinion, the reverse side of the latter assumption also holds. Any attempt to examine

[95] J. E. Campos and Hilton L. Root, *The Key to the East Asian Miracle: Making Shared Growth Credible* (Washington, D.C.: The Brookings Institution, 1996).
[96] Campos and Root, *The Key to the East Asian Miracle*, p. 7.
[97] Carles Boix, *Democracy and Redistribution* (Cambridge: Cambridge University Press, 2003).
[98] Barry R. Weingast, 'Rational-Choice Institutionalism', in Katznelson and Milner, eds, *Political Science*, pp. 660–92. fn 123 (19-41).
[99] Przeworski, 'The Last Instance'.
[100] See Riker, 'Implications from the Disequilibrium of Majority Rule for the Study of Institutions'; Tsebelis, *Nested Games*; Robert H. Bates, 'Contra Contractarianism', *Politics and Society*, 16 (1988), 387–401; Peter C. Ordeshook, 'The Emerging Discipline of Political Economy', in Alt and Shepsle, *Perspectives on Positive Political Economy*, pp. 9–30.
[101] Shepsle, 'Studying Institutions'.
[102] Tsebelis, *Nested Games*.
[103] Weingast, 'Rational-Choice Institutionalism'.

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the way institutions contribute to the process of economic development should rest upon a better understanding of the forces shaping the evolution of such institutions. This is important for comprehending the way politics mediates the relationship between institutions and economic performance, and for predicting the unintended consequences involved in the process of institutional change. Research in political economy is increasingly looking at the economic and political determinants of governance.[104] What is missing, and will be missing for some time, is a solid understanding of how economic and institutional processes evolve and interact dynamically.

POLICY IMPLICATIONS OF THE GOOD GOVERNANCE APPROACH

'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*, p. 191

The institutional political economy of growth is a research programme with very significant public policy implications. In this section, I will discuss the policy implications of the literature on institutions and economic performance in the light of the analytical critique presented above. In doing so, I will assess the plausibility of the good-governance approach to development implied in the discourse and actions of international organizations.

In the last decade, 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'.[105] The good-governance approach to development implies the application of the institutions-do-matter proposition in the realm of development research and policy. The name of the good governance game is 'convergence conditional on institutions': relatively poor countries can enjoy rapid catch-up growth if they adopt good institutions. The growing attention to governance issues has to be understood in the context of the neo-institutional revolution in social sciences, on the one hand, and the concomitant proliferation of empirical studies claiming a positive link between institutions and development outcomes, on the other. Yet this story is incomplete without an understanding of the political context shaping the conditions for the rise of the good governance discourse in international public policy. Actually, an explicit concern with good governance and its implications for development was aroused in the framework of the reformulation of the Washington Consensus, prompted by some of the disappointing outcomes of the first generation of market-oriented reforms.[106] As Daniel Kaufmann acknowledged: [107]

Less than a decade ago, governance issues did not figure prominently in the agenda of international financial and development institutions. Then there was no road: the absence of

[104] See, e.g. Knack, *Democracy, Governance, & Growth*; Chong and Gradstein, 'Inequality and Institutions'.
[105] Weiss, 'Governance, Good Governance and Global Governance', p. 796.
[106] The *1997 World Development Report* signalled a pivotal change in the development game by stating that 'good government is not a luxury; it is a vital necessity for development' (World Bank, *The Role of the State in a Changing World* (Oxford: Oxford University Press, 1997)). At almost the same time, the 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' (International Monetary Fund, *Good Governance: The IMF's Role* (Washington, D.C.: IMF, 1997)). Some critics argued that the good-governance discourse aimed at legitimizing the new politics of development. See Uma Kothari and Martin Minogue, *Development Theory and Practice: Critical Perspectives* (Basingstoke, Hants.: Palgrave, 2002).
[107] Kaufmann, 'Rethinking Governance', p. 3 (emphasis added).

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institutional and governance reforms was arguably the most glaring omission of the Washington 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*.

What are 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 with strong normative implications. Using information from a sample of 102 countries for the period 1960–90, Alesina 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'.[108] In the light of this finding, he 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.[109]

Institutional conditionality is based on (1) the belief that, under certain conditions, good institutions are a factor influencing economic development (the institutionalist claim), and (2) the expectation that cutting off assistance to countries with poor governance records may create incentives for institutional strengthening via moral hazard considerations (the conditionality claim). The methodological validity of both claims can be questioned. In particular, one may object to the use of perceptions-based indexes of governance performance to demonstrate a causal relationship between institutions and growth. Similarly, it can be argued that such a strong normative inference is unwarranted given the limited time-frame of the study.[110] But let us assume, for the sake of the argument, that this study is free of any serious modelling/measurement problems. Even if this were the case, the conditionality claim would be problematic because moral hazard arguments do not travel well from textbooks to the reality of developing countries. Unintended consequences are likely to come into play. Given that the real incentive structure of a society is made up of formal, informal and cognitive constraints, it is difficult to predict the ultimate outcome of attempts to create institution-building incentives through the manipulation of financial aid. The challenge is to demonstrate that the cutting of assistance would increase the probability of governance-enhancing reforms becoming self-enforcing. As the history of foreign sanctions/interventions shows, the outcome very much depends on the way domestic politics mediates the process linking aid-related incentives with institutional reforms.[111]

A critical issue here is the likely response of the political stability variable, which has significant effects in Alesina's regressions. In some circumstances, one can expect that the application of conditionality may lead to the deterioration of both governance and

[108] Alesina, 'The Political Economy of High and Low Growth', p. 217.
[109] Alesina, 'The Political Economy of High and Low Growth', p. 217 (emphasis added).
[110] For example, the analysis covers neither the critical 1990s nor the periods in which most of today's rich countries became developed.
[111] Another issue is 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?

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economic performance through the political instability channel. This brings us to the work of Feng. This study stands as one of the most comprehensive and innovative approaches to the empirics of governance and economic performance. However, it also reveals the uncertainties associated with translating the findings of econometric studies into concrete lessons for institutional policy. The central policy message of this work is that 'a nation can achieve ''economic miracles'' by reducing political instability, building policy certainty, and increasing political freedom'.[112] The puzzle is to identify what set of institutional reforms a misgoverned country should implement, and at which level, in order to strengthen the political foundations of its economic system. As suggested before, the real problem is that factors such as political stability and policy certainty are indeed outcome-variables, reflecting more the way in which the political game is played in different countries, rather than the actual institutional arrangements structuring that game.

Some of the measurement strategies chosen by Feng also suggest some pressing issues regarding policy implications. For example, he measures the level of policy certainty/uncertainty, one of the key variables driving his findings, using indicators of income distribution. The plausible assumption behind this choice is that a wide disparity of wealth polarizes societies and promotes conflict, thus undermining consensus about policies. This method of using measures of income inequality as proxies of governance-related concepts is common in the political economy of growth literature. There is nothing intrinsically wrong with such a measurement strategy provided it is supported by theory. The issue is, however, that a competing (i.e. less institutionalist) narrative about the political sources of underdevelopment can be constructed upon the observed relationship between income distribution and growth. Indeed, the problem of 'same data, leading to different conclusions' pervades the literature.[113] In this context, what are the actual policy lessons of Feng's study? He finds, for example, that 'political instability and policy uncertainty underscore the lack of economic performance in Latin America'.[114] However, we know that poor governance, high inequality and low rates of growth are inextricably linked in this region. Thus, it remains unclear whether Latin American countries should put the emphasis on institution-building or on delivering policies to tackle poverty and inequality.

Knack 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 performance'.[115] Aggregation might not be the real problem here. The real issue is that those aggregated indicators of governance are not even measuring institutions *per se*. Indeed, they are measuring at best 'structure-induced equilibria' and at worse 'policy equilibria'. Take the example of corruption. Since the path-breaking work of Mauro,[116] several articles have documented that corruption has growth-retarding effects.[117] However, what are the policy lessons of this empirical finding? In many developing countries, high levels of

[112] Feng, *Democracy, Governance and Economic Performance,* p. 37.
[113] Przeworski, 'The Last Instance', p. 168.
[114] Feng, *Democracy, Governance and Economic Performance,* p. 86.
[115] Knack, *Democracy, Governance, & Growth*, p. 294. With the aim of unbundling particular manifestations of misgovernance, the World Bank and other organizations have begun to develop surveys and in-depth in-country governance diagnostics.
[116] Mauro, 'Corruption and Growth', pp. 681–712.
[117] See, e.g., Alberto Ades and Rafael Di Tella, 'The New Economics of Corruption: A Survey and Some New Results', *Political Studies*, 45 (1997), 496–515; Vito Tanzi, 'Corruption around the World', *IMF Staff Papers*, 45 (1998), 559–94.

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corruption are equilibria 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 players' expectations. In addition, pervasive corruption is likely to flourish with the backdrop of poverty and inequality. In this context, it is not evident what kind of legal, institutional and public sector reform would be effective to curb corruption in developing countries.[118] As Rodrik highlights:[119]

> 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 also underlines the role of special interests and distributional politics in conditioning the relationship between institutions and economic outcomes. In an explicit attempt at 'rethinking governance', Kaufmann recognizes that corruption is also promoted by the behaviour of multinationals and powerful economic elites seeking undue influence in the policy process.[120] Having acknowledged this point, he questions the effectiveness of a narrow technocratic approach to anti-corruption, proposing instead a bolder and more encompassing framework for confronting the challenge of 'state capture'. His key assumption is that addressing governance issues requires an understanding of the 'complex political dynamics' in which 'misgovernance' takes place. In turn, this implies (1) moving beyond the blanket treatment of 'politics-as-an-obstacle' to governance reforms, and (2) abandoning the untenable assumption that the success of a given reform process depends on the 'willingness' of particular elites. Overlooking the political constraints shaping economic and institutional change is probably the most serious omission of the good governance approach to development. As Knack states: [121]

> 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.

The lesson is that we should be more active in studying the 'possibilities and limits' of institutional reforms.[122] The too-often-misinterpreted concept of path dependence may provide a useful starting point. According to North, path dependence simply means

[118] Fortunately, the scholarship on the institutional foundations of corruption is thriving. See Torsten Persson and Guido Tabellini, *The Economic Effects of Constitutions* (Cambridge, Mass.: MIT Press, 2003); Gabriella R. Montinola and Robert W. Jackman, 'Sources of Corruption: A Cross-Country Study', *British Journal of Political Science*, 32 (2002), 147–70; John Gerring and Strom Thacker, 'Political Institutions and Corruption: The Role of Unitarism and Parliamentarism', *British Journal of Political Science*, 34 (2004), 295–330; Jana Kunicova and Susan Rose-Ackerman, 'Electoral Rules and Constitutional Structures as Constraints on Corruption', *British Journal of Political Science*, 35 (2005), 573–606; Eric C. Chang and Miriam A. Golden, 'Electoral Systems, District Magnitude and Corruption', *British Journal of Political Science*, 37 (2007), 115–37. For a review of the political economy of corruption, see Rose-Ackerman and Luce, *International Handbook on the Economics of Corruption*.

[119] Dani Rodrik, *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton, N.J.: Princeton University Press, 2003), p. 8.

[120] Kaufmann, 'Rethinking Governance'.

[121] Knack, *Democracy, Governance, & Growth*, p. 295 (emphasis added).

[122] Eggertsson, *Imperfect Institutions*.

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'constraints on the choice set'.[123] Politico-economic processes are path-dependent because large-scale changes undermine the interests of groups with high stakes in the status quo, but also because shared mental models limit actors' choice set by defining the range of 'perceived legitimate change'.[124] While scholars are increasingly looking at how distributive conflicts constrain good governance,[125] the relationship between cognition and institutions does not figure prominently in the good-governance agenda. The challenge is to understand the way in which evolving beliefs 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 (1) identifying the sources of the imperfect enforcement of institutional reforms; (2) explaining why particular institutional paths are taken in the context of multiple equilibria; and (3) discovering the scope for institutional innovation.[126] In North's words: [127]

> 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.

We can conclude this section by referring to one traditional normative issue in development policy: the role of institutional reform in the process of economic development. During the 1990s, most experts within international organizations endorsed a bold, comprehensive and orthodox approach to structural reforms. However, Rodrik reviews a number of country narratives and concludes that 'the onset of economic growth does not require deep and extensive institutional reform'.[128] This raises questions regarding the scope, sequencing and pace of the reform effort needed to ignite and sustain long-term economic growth. Rodrik argues that the acquisition of good institutions often requires 'experimentation, willingness to depart from orthodoxy, and attention to local conditions'.[129] There are signs that the game is moving towards heterodoxy. Arguably, the development community seems to be increasingly sceptical of top-down, universal and rule-based reforms.[130] In a way, the 'rethinking of governance' has been motivated by the following uncomfortable reality: despite the consolidation of

[123] See especially Douglass C. North, 'Five Propositions about Institutional Change', in Jack Knight and Itai Sened, eds, *Explaining Social Institutions* (Ann Arbor: University of Michigan Press, 1995), pp. 15–26, at p. 20. As Levi explains: '[P]ath 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'* (see Margaret Levi, 'A Model, a Method, and a Map', in Lichbach and Zuckerman, eds, *Comparative Politics*, pp. 19–41, at p. 28 (emphasis added)).

[124] In his last book, North stresses that beliefs are at the core of the process of change. The complex structure of institutions affecting political economy performance is the result of beliefs and the way they are altered by feedback from changed perceived reality. See North, *Understanding the Process of Economic Change*, p. 4.

[125] See Knack, *Democracy, Governance, & Growth;* Bardhan, *Scarcity, Conflicts, and Cooperation*.

[126] For an innovative attempt to look at the cognitive constraints to development, see Elisa Reis and Mick Moore, eds, *Elite Perceptions of Poverty and Inequality* (London: Zed Books, 2005).

[127] North, *Understanding the Process of Economic Change*, pp. 163–4.

[128] Rodrik, *In Search of Prosperity*, p. 15.

[129] Rodrik, *In Search of Prosperity*, p. 12. See also Dani Rodrik, 'Growth Strategies', in Aghion and Durlauf, *Handbook of Economic Growth,* pp. 967–1014.

[130] See, e.g., World Bank, *Economic Growth in the 1990s: Learning from a Decade of Reform* (Washington, D.C.: IBRD, 2005). However, Rodrik shows that there are contending interpretations in the Washington community in relation to the role of institutions. See Rodrik, 'Goodbye Washington Consensus, Hello Washington Confusion?'

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the good-governance paradigm, developing countries have made scant progress in controlling corruption, strengthening the rule of law and improving institutional quality.[131]

INSTITUTIONS AND DEVELOPMENT: LESSONS FROM EAST ASIA AND LATIN AMERICA

The contrasting experiences of Latin America and East Asia are one of the highlights of growth econometrics. While seven of the eleven countries labelled by Knack as 'catch-up countries' in the period 1960–98 are from East Asia (Singapore, Hong Kong, Japan, Taiwan, Korea, Malaysia and Thailand), not even one is from Latin America. Not surprisingly, many Latin American countries have behaved as 'fall-back countries', with Argentina, Uruguay, Venezuela, Nicaragua and Peru showing the most depressing tales of relative economic decline.[132] The contrast is even starker when income distribution enters into the analysis. Whereas the 'Asian tigers' have achieved substantial redistribution in the context of a successful shared-growth strategy, Latin American countries are still at the top of world rankings of inequality.[133] I will not offer here a complete review of the political economy of Latin America and East Asia's divergent growth paths.[134] Instead, the idea is to take up some issues from the comparative experiences of these regions and relate them to our discussion. More specifically, I will analyse 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.

As mentioned above, the 'institutions versus policies' issue is at the core of the debate about the causes and implications of the East Asian miracle. On the one hand, some studies seem to suggest that good political institutions and secure property rights are the keys to economic success.[135] On the other hand, some authors argue that the impressive economic performance of a subset of Asian countries (including China) in the post-war period has been the result of the 'policy choices' made by their (mainly authoritarian) governments and not of the 'institutional constraints' placed on them.[136] This unsettled debate is relevant for contemporary Latin America, where in the context of disenchantment with neo-liberal reforms and left-leaning political realignment, the pendulum of the 'war of ideas' is swinging in direction of the policy approach.[137]

[131] Kaufmann, 'Rethinking Governance'.

[132] Knack, *Democracy, Governance, & Growth*, p. 7.

[133] Even Chile, Latin America's growth star, still has very high levels of inequality (though poverty has declined markedly). On the historical impossibility of reconciling growth and equity in Latin America, see Fernando Fajnzylber, *Unavoidable Industrial Restructuring in Latin America* (Durham, N.C.: Duke University Press, 1990).

[134] But see, e.g., R. Jenkins, 'The Political Economy of Industrialization: A Comparison of Latin American and East Asian NICs', *Development and Change*, 22 (1991), 197–231; Cristobal Kay, 'Why East Asia Overtook Latin America', *Third World Quarterly*, 23 (2002), 1073–102; World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Oxford: Oxford University Press, 1993); Nancy Birdsall, David Ross and Richard Sabot, 'Inequality and Growth Reconsidered: Lessons from East Asia', *World Bank Economic Review*, 9 (1995), 477–508; Gustav Ranis, 'Another Look at the East Asian Miracle', *World Bank Economic Review*, 9 (1995), 509–34.

[135] See Alesina, 'The Political Economy of High and Low Growth'; Feng, *Democracy, Governance and Economic Performance*.

[136] See Glaeser *et al.*, 'Do Institutions Cause Growth?'

[137] Nowhere is this pattern clearer than in Argentina, where the collapse of the convertibility system in 2001 destroyed the reputation of self-finding structural reforms and led to the adoption of a discretionary approach to policy making.

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The comparison between East Asia and Latin America also reveals the problem of reading too much institutionalism into the proposition that political institutions are the main sources of economic development. For example, political stability is one of the key variables explaining both relative economic growth in large-*N* studies and the contrasting performances of East Asia and Latin America.[138] But, as suggested before, analytical stretching may call into question the validity of this apparent institutions-to-growth mechanism. Political instability has evidently been one of the expected features of Latin American development. However, this outcome has been more associated with pervasive politico-economic disequilibria than with the features of the formal rules of the political game. Thus, it is unclear what analytical lessons can be drawn from the existence of a link between political stability and growth. This empirical finding should reactivate one of the oldest, and unresolved, debates in constitutional political economy. The challenge is assessing how alternative political systems (for example, forms of government and electoral rules) affect both political order and economic outcomes.[139]

The case of Bolivia, one of the poorest and most unstable countries in Latin America, illustrates the puzzles underlying the relationship between stability and growth. It is clear that misgovernance has been both the source and the consequence of this country's economic backwardness. However, what should a country like Bolivia learn from the literature on institutions and development? Mantzavinos provides one answer: 'secure property rights and economic institutions maintaining open markets are the appropriate formal rules for a wealth-creating game'.[140] However, as North points out, the transplanting of market institutions to the Third World has frequently altered income distribution and generated political instability, leading to consequences that were the reverse of the intended objective.[141] And, indeed, Bolivia has recently undergone a new perverse cycle of political and economic instability, which was precisely rooted in political contestation against the elite class's intentions to extend property rights in key areas such as mineral resources or water provision. This is one of the central unresolved tensions in the political economy of growth. There is an established literature showing that secure property rights provide incentives for growth by favouring production over predation.[142] However, another increasingly important research stream shows that social polarization reduces the security of contract rights and slows growth, and that inequality reduces growth in part through its effect on the security of property rights.[143]

The key political question is how to make wealth-creating economic institutions self-enforcing. Henisz claims that an institutional environment with many 'veto players'

[138] See Alesina, 'The Political Economy of High and Low Growth', and Feng, *Democracy, Governance and Economic Performance*.

[139] On the link between political order and economic growth, see North *et al*., 'Order, Disorder, and Economic Change'; Robert H. Bates, *Prosperity & Violence* (New York: Norton, 2001). For an interesting debate on constitutional political economy, see Torsten Persson and Guido Tabellini, *The Economic Effects of Constitutions* (Cambridge, Mass.: MIT Press, 2003); and Daron Acemoglu, 'Constitutions, Politics, and Economics: A Review Essay on Persson and Tabellini's *The Economic Effects of Constitutions*', *Journal of Economic Literature*, 43 (2005), 1025–48.

[140] Mantzavinos, *Individuals, Institutions, and Markets*, p. 245.

[141] North, *Understanding the Process of Economic Change*.

[142] See especially, *Knack, Democracy, Governance, & Growth*, pp. 1–24.

[143] See, e.g., Keefer and Knack, 'Polarization, Politics and Property Rights'; William Easterly, Josef Ritzen and Michael Woolcock, 'Social Cohesion, Institutions and Growth', *Economics and Politics*, 18 (2006), 103–20.

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induces economic growth by creating a credible commitment for non-interference with private investment and property rights.[144] However, this argument overlooks the historical dynamics of institutions and growth. As Tsebelis stresses, it is unclear 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'.[145] In this context, there might be a potential conflict between the checks-and-balances type of accountability implicit in the notion of good governance, on the one hand, and executive effectiveness in implementing pro-growth institutional reforms, on the other.[146] Weingast argues that a constitution respecting 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.[147] The problem is that constitutional provisions as honoured in the United States have rarely been self-enforcing in Latin America, where the resilient political economy of patrimonialism has continued to structure the incentives of the game.

Institutional solutions to credible commitment are themselves subject to problems of credible commitment.[148] In order to get around this conceptual conundrum, some political economists emphasize modelling the conditions supporting self-enforcing institutions.[149] The implication is that research on the effects of institutions on growth must include an analysis of the conditions under which productivity-enhancing institutions are likely to emerge and be sustained in equilibrium. As Greif 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'.[150] The question of what conditions make possible the signalling/enforcement of alternative commitment strategies is key to the political economy of East Asian success. Two sets of supporting conditions are critical here: distributional mechanisms and international factors.

The case of East Asia stresses the interdependence of the processes of accumulation and distribution. One area of active research in political economy focuses on the effects of income inequality on growth via the implied pressure for redistribution.[151] The new

[144] Witold J. Henisz, 'The Institutional Environment for Economic Growth', *Economics and Politics*, 12 (2000), pp. 1–31.

[145] George Tsebelis, *Veto Players: How Political Institutions Work* (Princeton, N.J.: Princeton University Press, 2002), p. 204.

[146] On this trade-off, see George Philip, 'The Dilemmas of Good Governance: A Latin American Perspective', *Government and Opposition*, 34 (1999), 226–42.

[147] Weingast, 'The Economic Role of Political Institutions'.

[148] Bardhan, *Scarcity, Conflicts, and Cooperation*, p. 62.

[149] See, e.g., Barry R. Weingast, 'The Political Foundations of Democracy and the Rule of Law', *American Political Science Review*, 91 (1997), 245–63; Boix, *Democracy and Redistribution*.

[150] Avner Greif, 'Self-Enforcing Political Systems and Economic Growth', in Robert Bates, Avner Greif, Margaret Levi, Jean-Laurent Rosenthal and Barry Weingast, eds, *Analytic Narratives* (Princeton N.J.: Princeton University Press, 1998), pp. 2–63, at p. 60. Similarly, Eggertsson shows that 'favourable background factors' conditioned Botswana's economic miracle (see Eggertsson, *Imperfect Institutions*, pp. 170–3). Specific political conditions have also supported credible commitment and sustained growth in Chile in the last decades.

[151] Drazen, *Political Economy in Macroeconomics*, p. 459. See also Alberto Alesina and Roberto Perotti, 'The Political Economy of Growth: A Critical Survey of the Recent Literature', *World Bank Economic Review*, 8 (1994), 351–71; Robert J. Barro, 'Inequality and Growth in a Panel of Countries', *Journal of Economic Growth*, 5 (2001), 87–120; Dimitri Landa and Ethan B. Kapstein, 'Review Article: Inequality, Growth and Democracy', *World Politics*, 53 (2001), 264–96.

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conventional wisdom is that inequality harms growth through both economic and political channels. Recent scholarship has also reported a strong causal effect running from income inequality to bad governance.[152] In the light of this evidence, East Asia's shared-growth model seems an attractive template for Latin American countries trapped in a bad equilibrium of 'misrule' of law, social polarization and stop-and-go growth. For example, progressive fiscal pacts may contribute to building political legitimacy and social consensus around a wealth-creating game. The puzzle is how to implement a shared-growth strategy that would not be undermined by the macroeconomics of populism; or how to introduce effective wealth-sharing mechanisms against a backdrop of pervasive clientelism. But, most importantly, there is an analytical lesson that should not be overshadowed by the shared-growth narrative. The discovery of virtuous circles between poverty reduction and growth should not lead to the *de-politicization* of the redistribution debate. Every transition towards a new distributive equilibrium is bound to be contentious and in conflict with the interests and beliefs of key elites.

The experience of East Asia also underscores the critical role of international conditions in supporting both accumulation and redistribution. For example, Campos and Root remark 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'.[153] As a case in point, the threat of communist takeover, made credible by a successful peasant-based revolution in China, eased the implementation of wealth-sharing mechanisms (notably land reform).[154] It is indicative that Ireland, Spain and Greece are also catch-up countries in Knack's analysis.[155] This suggests that the process of European integration has also provided a commitment device for countries seeking to reconcile growth and democracy. In the absence of these facilitating geopolitical conditions, the strategy of shared growth in East Asia, and the path of democratization with socio-economic progress in the European periphery, could have been out of equilibrium.

The ongoing discussion underlines the importance of further integration of international political economy (IPE) into the debate on institutions and growth. Several scholars have stressed the role of external conditions in supporting the rise and sustainability of institutional equilibria.[156] In addition, an exciting research agenda in IPE explores how international–domestic interactions affect national politics and institutions.[157] In particular, scholars are looking at the way in which globalization impacts on national democratic governance,[158]

[152] Chong and Gradstein, 'Inequality and Institutions'.

[153] Campos and Root, *The Key to the East Asian Miracle*, p. 2.

[154] On the geopolitics of the East Asian miracle, see Richard Stubbs, *Rethinking Asia's Economic Miracle: The Political Economy of War, Prosperity, and Crisis* (Basingstoke, Hants.: Palgrave Macmillan, 2005).

[155] Knack, *Democracy, Governance, & Growth*, p. 7.

[156] William H. Riker, *Federalism* (Boston, Mass.: Little Brown, 1964); Boix, *Democracy and Redistribution*.

[157] See, e.g., Robert O. Keohane and Helen V. Milner, *Internationalization and Domestic Politics* (Cambridge: Cambridge University Press, 1996); Jeffrey Frieden and Lisa Martin, 'International Political Economy', in Katznelson and Milner, *Political Science*, pp. 118–46; Joseph M. Grieco and G. John Ikenberry, *State Power + World Markets: The International Political Economy* (New York: Norton, 2003); Miles Kahler and David A. Lake, *Governance in a Global Economy* (Princeton, N.J.: Princeton University Press, 2003); David A. Lake, 'International Political Economy', in Weingast and Wittman, eds, *The Oxford Handbook of Political Economy*, pp. 757–77.

[158] Quan Li and Rafael Reuveny, 'Economic Globalization and Democracy: An Empirical Analysis', *British Journal of Political Science*, 33 (2003), 29–54.

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the link between international integration and corruption,[159] the domestic repercussions of international crises,[160] and the economic and governance consequences of foreign aid.[161] All these research streams may offer interesting insights into the mechanisms of governance and development.[162] A critical question is how the clash between international and national constraints shapes the constellation of national institutions.[163] Another related question is whether 'good governance' institutions promote sustainable growth in the context of globalization. For example, some authors suggest that the relationship between international integration and development is conditional on the quality of domestic institutions.[164]

In order to understand how domestic and international politics interact with institutional development in shaping the growth environment, we must look beyond the conventional property rights approach to institutions. Campos and Root's analysis of East Asia shows that a variety of institutional schemes supports credible commitments between governments, elites and citizens. For one thing, the co-operation of powerful economic groups was sought by the creation of 'institutions that facilitate the exchange of information between the public and private sectors'.[165] For another, East Asian leaders responded to the political challenges of economic growth by designing 'institutions that spread the benefits of growth-enhancing policies widely'.[166] Similarly, Rodrik stresses the role of the 'political institutions of conflict management' in determining the extent to which domestic conflicts triggered by external shocks are translated into growth-collapses.[167] Other authors pinpoint the importance of 'institutional complementarities'[168] and 'institutional interdependence'.[169] In this context, there is a case for unbundling governance and looking at the trade-offs and synergies associated with alternative institutional configurations.

The good-governance approach also underestimates the importance of the political management of economic change. Recent crises in Argentina, Bolivia and Ecuador have eloquently shown that market-oriented reforms often imply a tension between economic efficiency and social cohesion. In the presence of this unpleasant trade-off, we should be

[159] Wayne Sandholtz and Mark M. Gray, 'International Integration and National Corruption', *International Organization*, 57 (2003), 761–800.

[160] Dani Rodrik, 'Where Did All the Growth Go? External Shocks, Social Conflict, and Growth Collapses', *Journal of Economic Growth*, 4 (1999), 385–412.

[161] William Easterly, 'Can Foreign Aid Buy Growth?' *Journal of Economic Perspectives*, 17 (2003), 23–48; Roger C. Riddell, *Does Foreign Aid Really Work?* (Oxford: Oxford University Press, 2007).

[162] Some scholars even suggest that it is worth revisiting the merits of dependency theory. See Joe Foweraker and Todd Landman, 'Economic Development and Democracy Revisited: Why Dependency Theory is Not Yet Dead', *Democratization*, 11 (2004), 1–20; Lake, 'International Political Economy'.

[163] Suzanne Berger, 'Globalization and Politics', *Annual Review of Political Science*, 3 (2000), 43–62.

[164] Shang-Jin Wei, 'Risks and Rewards of Embracing Globalization: The Governance Factor' (paper prepared for the Plenary Session of the AERC Meeting, 2000); Ernesto Stein and Christian Daude, 'Institutions, Integrations and the Location of Foreign Direct Investment' (Washington, D.C.: Inter-American Development Bank, Research Department, mimeographed document, 2001).

[165] Campos and Root, *The Key to the East Asian Miracle*, p. 78.

[166] Campos and Root, *The Key to the East Asian Miracle*, p. 1. On the contrasting distributional paths of Latin America and East Asia, see also Hilton L. Root, *Capital and Collusion* (Princeton, N.J.: Princeton University Press, 2006).

[167] Rodrik, 'Where Did All the Growth Go?'

[168] Hall and Soskice, *Varieties of Capitalism*.

[169] North, *Understanding the Process of Economic Change*, p. 157.

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cautious in interpreting some empirical findings. For example, some authors have found that economic freedom promotes economic growth.[170] However, as Karl Polanyi famously asserted: markets constitute a powerful source of socio-political change and produce equally powerful responses as societies attempt to protect themselves against market forces.[171] Thus, the expected benefits of governance-enhancing reforms are conditional on governments' capacity to articulate them politically. Institutions may play a role in this process by affecting governments' ability to accommodate change. Indeed, a key source of long-run economic success might be adaptive efficiency: 'a set of institutions that readily adapt to the shocks, disturbances, and ubiquitous uncertainty that characterize every society over time'.[172] Good governance puts emphasis on the credibility/stability of the rules of the game. However, the notion of adaptive efficiency suggests that 'institutions too have to change in order to promote growth'.[173] Indeed, institutional stability involves a great deal of 'institutional adaptation'.[174] Latin America's stop-and-go growth may be rooted in governments' inability to accommodate the institutional stability/institutional adaptation trade-off.

We can conclude this section by emphasizing the value of understanding economic development as a process.[175] While many societies are still trapped in the deeply rooted equilibria of misgovernance, inequality and economic stagnation, other countries have managed to break with history. The crucial lesson of successful cases is that wealth-creating policies/institutions generally become self-enforcing in the context of specific conditions, including the memory of bloody civil wars and dictatorships, the threat of communist takeovers and processes of regional integration.[176] By stressing the dynamic features of development, I am not neglecting the policy relevance of theory-informed empirical research. Yet 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. The conditions supporting credible commitment and growth in the past might not be replicable. Nevertheless, rigorous 'contextualized comparisons' can inform a discussion about the global and domestic governance changes required to 'approximate' the conditions facilitating a marriage between growth and social progress. For example, the East Asian experience shows that policy-generated political consensus matters for development, underlining the importance of addressing the 'legitimacy gaps' of pro-growth reforms in Latin American countries.

[170] James Gwartney, Robert Lawson and Randall Holcombe, 'Economic Freedom and the Environment for Economic Growth', *Journal of Institutional and Theoretical Economics*, 155 (1999), 643–63; Wenbo Wu and Otto A. Davis, 'The Two Freedoms, Economic Growth and Development', *Public Choice*, 100 (1999), 39–64.

[171] Karl Polanyi, *The Great Transformation,* 2nd edn (Boston, Mass.: Beacon Press, 2001), pp. 3–4, 79–80.

[172] North, *Understanding the Process of Economic Change*, p. 78.

[173] Helpman, *The Mystery of Economic Growth*, p. 140.

[174] Kathleen Thelen, 'How Institutions Evolve', in James Mahoney and Dietrich Rueschemeyer, eds, *Comparative Historical Analysis in the Social Sciences* (Cambridge: Cambridge University Press, 2003), pp. 208–40, at p. 225.

[175] For an approach to economic development as a process, see James M. Cypher and James L. Dietz, *The Process of Economic Development* (London: Routledge, 2004).

[176] On the importance of placing institutional politics in time, see Paul Pierson, *Politics in Time* (Princeton, N.J.: Princeton University Press, 2004); North, 'What Is Missing from Political Economy'.

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CONCLUSION: WHERE DO WE GO FROM HERE?

'Not only does governance matter, but research contributing to our understanding of governance matters.'

Stephen Knack, *Democracy, Governance, & Growth*, p. 295

The literature on governance, institutions and growth is a progressive research programme seeking to identify the binding political and social constraints on development and to propose ways for overcoming them. The critique I have presented in this article should not lead to the conclusion that the conceptual lenses of new institutionalism/political economy have no leverage for uncovering some of the remaining puzzles of economic growth. In the same way, I do not want to discourage much-needed efforts in the areas of improving governance indicators and modelling the determinants/effects of institutions in cross-country regressions. On the contrary, I highlighted the analytical gaps in the literature with the aim of signalling ways of consolidating this fascinating and open-ended inquiry on the political foundations of development. In this conclusion, I shall outline the main arguments of the article, focusing on spelling out an agenda for further research.

At the analytical level, I claimed in this article that further comparative research on institutions and development should rest upon modelling/measurement strategies that (1) avoid the conflation of policies and institutions; (2) address the problem of conceptual stretching by unbundling the political and the institutional embedded in the notion of governance; (3) consider the role of the state and state formation in economic development; (4) discriminate between the rules of the game, the play of the game, and its outcomes; (5) take into account the difference between the structure, the structure-induced equilibrium and the policy equilibrium; (6) capture the way informal constraints and enforcement mechanisms mediate the relationship between formal institutions and outcomes; (7) recognize the critical importance of beliefs and human learning in the processes of economic and institutional change; (8) move beyond a narrow property rights approach to development; (9) stress the role of special interests and the distributional implications of institutions; (10) attempt to integrate the logics of accumulation/co-operation politics and distribution/contentious politics; (11) look at the sources of credible commitment and self-enforcing institutions; and (12) seek to reconcile theories of institutional effects and theories of endogenous institutions.

The good governance consensus faces a critical policy gap. Despite the growing acceptance that institutions matter for development, there has been little evidence of improvements in the performance of global governance in the last decade. Additionally, comparative studies on the economic effects of institutions rarely provide working principles for 'institutional policy'. In principle, an institutionalist should demonstrate that the design/modification of the structure of certain institutions would produce better results given an evolving configuration of power/preferences. This task is more demanding from a Northean perspective, as the play of the game depends on an institutional matrix made up of formal and informal constraints, and on the way enforcement/cognitive mechanisms mediate the relationship between incentives and actual choices. In this context, attempting to improve the economic performance of a country by transplanting formal institutions is a recipe for disappointment, not to say disaster.[177]

[177] North, *Understanding the Process of Economic Change*, p. 161.

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Clearly, more research on the politics of institutional change is in order. In particular, I believe future agenda should focus on (1) uncovering the domestic and international determinants of good/bad governance; (2) exploring the links between formal and informal constraints; (3) assessing the sources of imperfect enforcement; (4) investigating how special interests and evolving beliefs shape degrees of freedom in institutional design; (5) studying the trade-off between 'institutional credibility' and 'institutional adaptation'; and (6) unbundling governance and analysing the role of 'institutional complementarities' and 'interdependent institutions'.

Demonstrating that growth is a function of good institutions is of little help if this is not followed by an analysis of how such institutions emerge and become self-enforcing. Our knowledge about how rules arise, evolve and change is still insufficient.[178] As a result, the good-governance approach is handicapped by a limited understanding of how politics and social processes condition the relationship between institutions and outcomes. Our discussion of East Asia and Latin America offers important insights. First, it raises questions about the relative significance of institutional reforms *vis-à-vis* policy choices in the formulation of growth strategies.[179] Secondly, it stresses that foreign–domestic interactions seriously constrain institutional evolution and self-enforcing growth. Thirdly, it illustrates that a wide range of institutional mechanisms may support sustained growth by solving co-ordination failures, facilitating public–private co-operation, and articulating distributional struggles. Fourthly, it shows that the solution of multiple credible-commitment problems, regarding both accumulation and distribution, underpins the political conditions for economic growth. Last, but not least, it suggests that the way in which income inequality interacts with institutional development and growth is key to understanding divergent development paths. All these themes are likely to attract academic attention in the near future.

I would like to conclude by pointing out some methodological issues deserving attention. Growth econometrics will have to address the remaining modelling uncertainties. The quality of available measures should also improve. However, it is worth emphasizing that conceptualization must be the first step towards measurement. Taking seriously the issue of the formation of concepts is critically important for enhancing the validity of extant good-governance indicators.[180] Future research will also have to identify the channels through which institutions affect growth and the ways in which various institutions interact.[181] However, cross-national studies are not always good for uncovering the mechanisms of development.[182] This creates a demand for small-*N* studies looking at

[178] For some frontier research on endogenous institutions, see Mantzavinos, *Individuals, Institutions, and Markets;* Weingast, 'Rational-Choice Institutionalism'; Philippe Aghion, Alberto Alesina and Francesco Trebbi, 'Endogenous Political Institutions', *Quarterly Journal of Economics*, 119 (2004), 565–612; Daron Acemoglu and James A. Robinson, *Economic Origins of Dictatorship and Democracy* (Cambridge: Cambridge University Press, 2006); Avner Greif, *Institutions and the Path to the Modern Economy* (Cambridge: Cambridge University Press, 2006).

[179] This crucial debate continues to divide the development community. See Rodrik, 'Goodbye Washington Consensus, Hello Washington Confusion?'

[180] See R. Adcock and D. Collier, 'Measurement Validity: A Shared Standard for Qualitative and Quantitative Research', *American Political Science Review*, 95 (2001), 529–46; Marcus J. Kurtz and Andrew Schrank, 'Growth and Governance: A Defense', *Journal of Politics*, 69 (2007), 563–9.

[181] Helpman, *The Mystery of Economic Growth*, p. 141.

[182] Bardhan, *Scarcity, Conflicts, and Cooperation.*

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the institutional sources of self-enforcing growth.[183] Indeed, real progress in this field will require a closer dialogue between (1) the game-theoretic literature on institutions, (2) econometric studies on governance and development, (3) context-specific country narratives, and (4) the methodological literature on conceptualization and measurement.[184] Critically, this dialogue should put more emphasis on integrating economic and political ways of reasoning. After all, the only recipe for progress in solving the puzzles of institutional and economic change is a fruitful conversation between theory and empirics, and between economists and political scientists.

[183] Context-specific analyses are also needed because processes of institutional formation might have 'multiple equilibria'. On the analytical gains of consciously-designed case studies, see Dietrich Rueschemeyer, 'Can One or A Few Cases Yield Theoretical Gains?' in Mahoney and Rueschemeyer, *Comparative Historical Analysis in the Social Sciences*, pp. 305–36; Lee J. Alston, 'The Case for Case Studies in Political Economy', *Political Economist*, 12 (2005), 1–21; Alexander L. George and Andrew Bennett, *Case Studies and Theory Development in the Social Sciences* (Cambridge, Mass.: MIT Press, 2005); Andrew Bennett and Colin Elman, 'Recent Developments in Case Study Methods', *Annual Review of Political Science*, 9 (2006), 455–76; John Gerring, *Case Study Research* (Cambridge: Cambridge University Press, 2007). For insightful analytical cases studies on the politics of economic growth, see Rodrik, *In Search of Prosperity*.

[184] On the promises of cross-method approaches, see Margaret Levi, 'An Analytic Narrative Approach to Puzzles and Problems', in Ian Shapiro, Rogers M. Smith and Tarek E. Masoud, eds, *Problems and Methods in the Study of Politics* (Cambridge: Cambridge University Press, 2004), pp. 201–26; E. Lieberman, 'Nested Analysis as a Mixed Method Strategy for Comparative Research', *American Political Science Review*, 99 (2005), 435–52; Andrew Bennett and Colin Elman, 'Qualitative Research: The View from the Subfields', *Comparative Political Studies*, 40 (2007), 111–21; Jack S. Levy, 'Qualitative Methods and Cross-Method Dialogue in Political Science', *Comparative Political Studies*, 40 (2007), 196–214; Detlef F. Sprinz and Yael Wolinsky-Nahmias, eds, *Models, Numbers & Cases* (Ann Arbor: University of Michigan Press, 2004).

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