

Governance Reforms and Growth:  
Some Ideas from Economic Theory\*

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ABSTRACT

Ideas from the theory of incentives and organization are deployed to examine how some aspects of economic governance – primarily protection of property rights, enforcement of contracts, and oversight regulation – can be improved for achieving better economic growth and development. Some suggestions for reform of governance institutions in developing countries are offered.

INTRODUCTION

As recently as 35 years ago, the word “governance” had rested almost unused for decades. I believe that it was the former British Prime Minister Harold Wilson who brought it back into general circulation, by entitling his 1976 memoirs *The*

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*Governance of Britain*. Reviewers praised him for reviving an archaic word. Since then it has moved rapidly from obscurity to ubiquity.

The Oxford English Dictionary defines many senses of the word, including: (a) Controlling, directing or regulating influence; control, sway, mastery. (b) The state of being governed; good order. (c) The office, function or power of governing; authority or permission to govern; the command of a body of men or ship. (d) The manner in which something is governed or regulated; method of management, system of regulations. (e) Conduct of life or business; mode of living, behavior.

With so many meanings, it is hardly surprising that the word is used, and misused, so much. But all these senses have common features: they pertain to processes, institutions, or organizations of governing, not specific actions. Therefore governance is about a more basic, deeper level of policymaking than any one policy choice or outcome. If outcomes are undesirable, reforms should operate on the mechanisms that produced them. Of course it can be argued that ultimately only the actual policies matter, and institutions that appear bad according to some general criteria can produce good policies, but it would be unwise to rely on such fortuitous results.

This still leaves a very large scope for the concept of governance: the political, legislative, executive and administrative processes, institutions, and organizations that make and implement the rules and policies in a society, country, or groups of countries. For the purpose of this paper, I narrow down the focus. I consider only governance in its economic aspects. Even there, my main concern is with the formal legal and informal social institutions that underpin economic activity and market transactions by protecting property rights, enforcing contracts, regulating market conduct, and providing the requisite public goods, including physical and organizational infrastructure. Although I discuss aspects of macroeconomic policymaking in so far as it relates to my main theme, issues like fiscal constitutions, central bank independence, or institutions of financial regulation are not my main concern here.

The importance of good governance for good economic performance is intuitively obvious, and has been demonstrated in theoretical models, historical case

studies, and empirical statistical analyses. I will not expend time on this literature today, but merely refer to previous surveys, and proceed to discuss reforms.<sup>i</sup> I will keep my discussion informed by economic theory. Modern theory of information and incentives has a lot to say about the design and functioning of institutions of economic governance, and I will suggest some reforms based on some of these – fortunately simple but powerful – ideas.

Experience shows that countries can progress economically to middle-income levels despite mediocre governance, but further growth requires much better institutions (Easterly 2001, 234-35, 245-48; Rodrik 2003, 16-17). This stage has just arrived in many countries including Brazil, China and India, which account for a very large proportion of the world's population. Therefore ideas for reforms to improve governance institutions are especially timely.

To illustrate the relationships between various aspects of governance and economic success, Table 1 shows the 2013 World Bank's Governance Indicators and Ease of Doing Business rankings for these three countries, and for a small comparison sample of countries with high and low levels of governance and incomes. The Governance Indicator ratings range from 0 (worst) to 100 (best); the Ease of Doing Business rankings go from 1 (best) to 189 (worst). The numbers tell a clear and dramatic story.<sup>ii</sup> The three middle-income countries generally have reasonable levels of governance, but with much room for improvement to get to a good-governance, high-income status. Perhaps a positive feedback and a virtuous circle can form, where better governance in one country gives it an advantage in attracting investment and trade, which increases the pressure on others to follow suit.

Table 1 – Governance indicators for a sample of countries

Country	World Bank's Governance Indicators						Ease of Doing Business ranking
	Voice and Accountability	Political Stability and No Violence	Governmental Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption	
Denmark	99.53	78.20	99.04	97.61	98.58	100.00	4
United States	83.89	65.88	90.91	86.60	90.52	85.17	7
Brazil	58.77	36.97	51.20	54.55	52.13	55.02	120
China	5.21	27.01	54.07	42.58	39.81	46.89	90
India	61.14	12.32	47.37	33.97	51.61	35.89	142
Afghanistan	9.95	24.17	12.92	2.39	2.37	2.87	171
Zimbabwe	13.27	1.42	7.18	11.00	1.42	1.91	183

Source: <http://info.worldbank.org/governance/wgi/index.aspx#home> and <http://www.doingbusiness.org/rankings> , accessed August 4, 2015

## TWO THEMES

Two themes recur throughout in this paper. First, although major institutional and organizational reforms are needed to improve the quality of governance, no country has perfect institutions, and no country ever will. Property rights and contracts are never and nowhere 100% secure. Legislative and administrative institutions are everywhere plagued by multidimensional problems of asymmetric information and agency. A sensible strategy for reform will look for opportunities to improve the institutions and processes, but pay due attention to these unavoidable limits. A strategically aware reformer should also be vigilant, and oppose arguments that a proposed reform should be rejected because it is not perfect; this is sometimes offered as an excuse that hides self-interest in preserving the status quo. Nothing's perfect and nobody's perfect. We must settle for the feasible least imperfect.

Second, although all good institutions have to perform similar functions, they can take many different forms and use many different mechanisms: the formal legal system, formal state regulatory agencies, social networks with their norms of behavior and sanctions for misbehavior, business groups with their internal arbitration procedures for resolving contractual disputes and for self-regulation, and so on. Different historical, social, political and economic circumstances call for different modes of governance.<sup>iii</sup> Judgment about the efficacy of a set of institutions, and efforts for reform, should be guided by this consideration of appropriateness in the context.

## ISSUES AND CONCEPTS

Good contract enforcement enables people and firms conduct their transactions with others in reasonably secure knowledge that the counterparties will fulfill their specified obligations. Contract governance can be problematic for reasons of information and commitment. To get a contractual commitment enforced

in a court of law, the plaintiff must present a case to an appropriately high standard of proof; this requires publicly observable information about the contingencies specified in the contract. Even if this is available, the court itself may be inexpert, inefficient, biased, or corrupt. If contract governance is imperfect, then some or all parties to a contract will be tempted to act opportunistically to seize their own ex post gains at the expense of others, or to shirk or misbehave for private gains while inflicting losses on counterparties.

Of course the potential losers, anticipating this, will not enter into such contracts in the first place; much money will be left on the table. It is in everyone's interest to avoid this inefficiency, to strike an efficient bargain and divide its fruits to be benefit of both or all. Therefore before the transaction, everyone prefers better governance. After signing the contract, some or all want to behave opportunistically, seeking loopholes in the contract or exploiting weak enforcement so as to shirk or renege on the agreement.

Therefore, even if external enforcement by the government is ineffective or too slow or corrupt, people will attempt to devise alternative institutions that replace some of the functions of the state's governance. All businesspeople except a few fly-by-night operators will also find it in their long-term interest to work to improve the state's governance institutions, even though many of them will be tempted to evade enforcement and sneak an advantage over others in any one instance. I will discuss some examples of this, and make some suggestions for reform along these lines.

## OPTIMAL IMPERFECTION

Security of property rights is important; without it, individuals and firms will fear to make investments or create or improve any kind of asset. But the security is never ironclad or 100% in any country and at any time.

Lamoreaux (2011) argues convincingly that absolute security of property rights is not best for economic development. Property needs to be reallocated in response to changes in technological and other economic circumstances. This often

requires getting together with owners of other assets to achieve the newly optimal allocation. In an ideal world, existing owners can get together with the potentially more productive users of a property and strike a deal that secures the efficient outcome and divides up the resulting surplus to their mutual benefit. But in practice transaction costs can preclude such Coasian bargains. Then the necessary collective action may be better undertaken using the government with its coercive powers to acquire and redeploy the assets. Most countries' laws contain such provisions of "eminent domain," which allow private property to be seized for larger public purposes, without the owner's consent, albeit with compensation determined according to specified rules. The downside, of course, is that the government may act in a high-handed and arbitrary way, may not pay adequate compensation to previous owners, and may not make socially optimal use of the acquired property.

In 2005 the U.S. Supreme Court ruled in favor of the city of New London, Connecticut, which had claimed powers of eminent domain to acquire some private homes – not for a direct public purpose like building or widening a road, but in order to promote development of restaurants, stores etc. to revitalize the downtown waterfront. This was criticized as taking away one person's private property for another's private gain, and therefore an excessively broad interpretation of the power of eminent domain. Similar suspicions exist in many instances in developing countries like China and India. For example, in India the West Bengal government attempted to use eminent domain to acquire land for the Tata Nano factory by displacing farmers in Singur, but had to abandon the project in face of mass protests.

Contract enforcement is likewise never absolute. Circumstances that make it impossible for one or all parties to a contract to fulfill their obligations do arise, and sensible avenues of renegotiation are always open *de facto* if not *de jure*. The law does recognize *force majeure* clauses that essentially free one or both parties from their contractual liability or obligation if extraordinary events or circumstances that are not reasonably foreseeable and beyond their control, such as a war, strike, riot, or an act of God (a legal term covering hurricanes, floods, earthquakes, volcanic eruptions, etc.), prevents them from fulfilling these obligations.<sup>iv</sup> Most legal systems contain procedures to recognize bankruptcy of firms or individuals, and to deal with

the consequences. When debtors cannot to pay in full, lenders often agree to renegotiate and restructure the contract, accepting partial repayment, or an equity stake that gets them to share the risk, instead of holding out for full settlement and thereby risking getting nothing.<sup>v</sup> As with the overuse of eminent domain to override property rights, sometimes force majeure and related provisions can be misused. U.S. firms, especially airlines and automakers, have used the Chapter 11 bankruptcy route to rewrite their contracts with labor unions. (Of course top managers in these and other firms often claim that their own bonuses and golden handshakes are contractually sacrosanct!) And homeowners in the U.S. have walked away when their homes were worth less than they owed on the mortgage, even when they could afford to pay their full interest and capital obligation. My general point is that contract enforcement is unavoidably less than 100% rigid, and we need sensible procedures to handle true inability to fulfill the obligations while being vigilant about the moral hazard of opportunistic unwillingness to do so.

#### ACHIEVING THE RIGHT BALANCE

What, then, is the right balance between the security of property rights and contracts on one hand, and responsiveness or flexibility of asset use on the other? And what are the best institutions for sustaining such balance? Although the exact boundary is difficult to demarcate and may change over time, good institutions to decide cases and resolve disputes will enable societies to stay close to maintaining the optimal balance. In my judgment, these arrangements should have four key features: [1] The procedures for deprivation of property or breaking of contracts, and determining the compensation for doing so, should be rule-based, not left for ad hoc or arbitrary determination in each case. [2] The process should be transparent, conducted in an independent forum (court or committee) that is open to public scrutiny. [3] The person or firm that stands to lose its property, or to suffer loss because of an abrogation of a contract by a counterparty, should have the full opportunity to make its case heard in an independent and impartial judicial forum or political process. However, it should not be allowed to string out the process



indefinitely by repeated appeals and new filings; this is just another balance that needs to be struck in this world where nothing is perfect and nobody's perfect. [4] Authorities such as legislatures, courts, or bureaucrats who wield powers to cancel property rights or violate contracts should be accountable – subject to higher-level judicial review, and firing or electoral defeat in case of persistent wrongful use of their powers.<sup>vi</sup>

How do developing countries fare on these criteria? My impression yields a mixed verdict. [1] Rules exist on paper, but are sometimes bypassed in practice. [2] Democracies do well on transparency, especially if they have a sufficiently large educated population and a tradition of a free and vocal press; authoritarian regimes do less well.<sup>vii</sup> [3] Voice is difficult and costly, especially for poor and disadvantaged groups, but volunteer activists help them overcome the obstacles to quite some extent. [4] In many countries decision-makers are accountable in principle, but in practice political elites and bureaucracies can cover up and protect their own people.

Arbitrary or unpredictable changes of policies are particularly harmful for investment and growth. They make the returns to investment more uncertain, and as we know from the theory of real options (Dixit and Pindyck 1994), that is a powerful deterrent to investors. They find it optimal to wait until the future is clearer, which may in practice take forever.

Even corruption may be less harmful if it is predictable. To be sure, it acts just like a tax and reduces investment, but growth can proceed despite high taxes, albeit more slowly, as we see from the examples of the U.S. in the 1950s, and Scandinavian countries for many decades. Unpredictable corruption – not knowing when another demand may come from another official, and fearing that once an investment is sunk it is all the more prone to such hold-ups – is a much more powerful deterrent to investors; see for example Tanzi (1998). Therefore establishing predictability may be the most important reform.

## BUSINESS COMMUNITY SELF-REGULATION

I argued above that everyone can benefit from good governance institutions that enable them to make commitments and control moral hazard. But these institutions can take different forms.<sup>viii</sup> Businesspeople are generally averse to government regulation, and prefer industry-based self-regulation. Examples include arbitration tribunals and better business bureaus. When these are functioning well, there is a lot to be said for them. But when not, I believe that business's gut-reaction opposition to the government's oversight is mistaken. Submitting oneself to the scrutiny of a good regulatory authority can serve as credible commitment, and a signal of good behavior. Counterparties in trades, and investors, will come to expect this. Those who have not joined this set of businesses will feel the pressure to join. Eventually the set of adherents to the discipline of good governance will include almost all legitimate businesses.

Industry-based arbitration can be a good way of settling contract disputes because the judges have insiders' knowledge of norms and practices that are often not fully spelled out in contracts, because their industry expertise enables them to evaluate evidence more quickly and accurately than can judges in general courts, and because industry insiders' ability to exclude miscreants from future business constitutes a severe punishment that acts as a good deterrent. Bernstein's (1992, 2001) studies of such institutions of private order are among the best known. Courts recognize the advantages of these arrangements, and adopt forbearance: if the loser in such an arbitration refuses to abide by the verdict, the court will not rehear the case, but merely stand ready to enforce the arbitrators' judgment. Theoretical analyses of such "private governance under the umbrella of state law," include Dixit (2004, chapter 2).

Better Business Bureau (BBB) in the U.S. and Canada is an organization with local chapters, each of which gathers and keeps records about the firms in its area in matters of quality, reliability etc., based on past complaints and other factors such as longevity, and provides a dispute resolution service. The practices of BBB – mainly

suspicion of favoring businesses that pay the organization's fees – have been criticized, but on the whole it provides a useful public service.<sup>ix</sup>

Elites among businesspeople in developing countries should take the lead in establishing and sustaining such certification and arbitration organizations. Honest ones who intend to stay in business a long time have nothing to lose and everything to gain from making a visible commitment to have their behavior under public scrutiny. This will enable them to attract more business and increase their profits; it will also help identify and isolate the fly-by-nighters and thereby protect the public. This seems a win-win situation for all the good guys.

An interesting example of private monitoring comes from Whitaker (2010, pp. 55-56). About a hundred years ago, the American Medical Association acted as a watchdog of the pharmaceutical industry. It set up a Council on Pharmacy and Chemistry to test drugs. The purpose was to expose the so-called “patent” medicines with “secret” ingredients that were sold by thousands of small companies, and distinguish them from those produced by emerging major drug companies like Merck, which had some chemical scientific basis. The AMA gave its members an annual “useful drugs book,” and gave these drugs its seal of approval. It did this, not from any larger social concern, but for the private financial benefit of its members: doctors armed with this knowledge could prescribe drugs that worked, which gave patients a good reason to visit doctors. But the public derived considerable benefit from this service. Government regulation did not come in until the Food and Drug Act of 1938, and later laws that restricted availability of most new drugs on a “doctor’s prescription only” basis. But this aligned the interests of AMA members and drug companies, and the AMA’s oversight function lapsed. Perhaps similar efforts can contribute to combating problems of purity of drugs and other consumer products that have emerged in China, India and other developing countries.

## ANTI-CORRUPTION ORGANIZATION

Self-regulation can even make a contribution to fighting corruption, which is endemic in many countries and has been recognized as one of the biggest obstacles

to economic efficiency and growth. Many governments, including most recently China, have launched anti-corruption drives. These usually target what might be called the “demand side” of corruption, namely detecting and punishing officials who demand bribes for various favors given to businesses and citizens. Business associations can usefully complement these efforts by launching initiatives that target the “supply side”. The idea is to establish a community norm of not giving bribes, and enforce it by ostracizing any business that is found to have won a government license or contract through bribery. Dixit (2015 a, b) examines some theoretical and practical requirements for such a scheme to get started and to function.

## GOVERNMENTAL REGULATION

Can industries be relied on to regulate themselves? A recent notorious failure with huge consequences came from the financial industry. Indeed, the actions of many banks and other financial institutions – excessive leveraging and risk-taking, failure to disclose some of these risks to customers, secretly taking positions where the firms profited from its customers’ losses, and in some cases outright fraud – were so egregious as to shake the faith of that staunchest advocate of unregulated markets, Alan Greenspan:

“The Greenspan Doctrine – a view that modern, technologically advanced financial markets are best left to police themselves – has an increasingly vocal detractor. His name is Alan Greenspan. ... [He used to believe that] “enlightened self interest of owners and managers of financial institutions would lead them to maintain a sufficient buffer against insolvency by actively monitoring and managing their firms’ capital and risk positions,” the Fed chairman said. The premise failed in the summer of 2007, he said, leaving him “deeply dismayed.”

Self-regulation is still a first-line of defense, Mr. Greenspan said. But after the financial collapse of 2007 and 2008, “I see no alternative to a set of

heightened federal regulatory rules of behavior for banks and other financial institutions.”<sup>x</sup>

I hope financial institutions and businesses in countries like China and India will prove more thoughtful than their U.S. counterparts, and will intelligently combine self-governance when it works well, and the state’s regulatory agencies in other situations, to monitor and enforce good behavior in matters of contract and property. Of course they must remain vigilant to ensure that the purpose of regulation remains limited to achieving good governance, and that its procedures have the same key features – being rule-based, open, transparent, non-discriminatory, and accountable – that I advocated for eminent domain and contract renegotiations. The watchdogs of the public – courts, media, and even economists – should likewise remain vigilant to ensure that the regulation encourages rather than reduces competition. But with such vigilance, good oversight regulation can be devised and practiced to reduce misbehavior that can inflict large costs on society.

Of course government regulation has its own problems: it can be captured by the incumbents, and can serve as a device that deters entry, protects incumbents, and reduces competition, instead of one that monitors the firms’ adherence to contracts and promises. But total lack of regulation is often worse.

## MULTIPLE DIMENSIONS

In an increasingly complex economy, governance institutions become unavoidably complex. Each handles many tasks; each has numerous officials who interact in hierarchical and parallel structures; information is not equally available to all functionaries; each institution is answerable to many different constituencies with different objectives. This multidimensionality can create problems; good design of the structure of these institutions, and of the incentives for their personnel, should recognize the problems and minimize their impact to the extent feasible. The theory of mechanism design gives some useful ideas for this.<sup>xi</sup>

The general idea of mechanism design is that the person or institution at the top level of policymaking – the principal – uses one or more managers or employees

– the agents – to perform the necessary tasks. The reason for using agents may be that they have appropriate skills or superior information, or quite simply that the number of tasks and the amount of effort is beyond what the principal can do, as is sure to be the case in any economy or society of even moderate complexity. The agents must be rewarded for their services, and since the principal cannot directly monitor their actions and does not have access to their information, they must be given incentives to exert the proper effort and use the information. The principal's mechanism design problem is that of choosing this reward (or punishment where feasible) scheme.

The first of the insights I want to use is based on the very simple familiar distinction between substitutes and complements. Consider an agent who performs multiple tasks. Two tasks are substitutes (resp. complements) if exerting more effort on one reduces (resp. increases) the marginal product of effort on the other. In the substitutes case, if the principal increases the agent's marginal reward for one task, that reduces the marginal benefit from the other task, which is bad for the principal. Therefore the agent's incentives for the two tasks interfere with each other. The result is that the principal must accept weak incentives all round. But if two tasks are complements, then the incentives offered for each have the additional benefit of increasing the marginal product on the other. Incentives reinforce each other; the principal can offer powerful incentives for each task without fearing bad effects on the other.

The same distinction also helps in the prior stage of designing the structure of the organizations themselves. Policy implementation involves numerous tasks; because of the limits of span of control in organizations, it is necessary to split the tasks among several departments or agencies of the government or of a large firm. Which tasks should be gathered together in one agency, and which ones should be separated into distinct agencies? The above intuition yields an immediate answer: keep complements together and substitutes apart. Then each agency can have powerful incentives for all the tasks under its umbrella, without harming the incentives on substitute tasks that are in other agencies.

An example close to home for us academics illustrates the difference. Are teaching and research in academia substitutes or complements? If substitutes, then giving powerful incentives – promotion, salary increases, prizes, honors etc. – for research will cause professors to neglect teaching, and vice versa. As a result, university administrators will have to offer weaker incentives for both. When designing organizations, it will be better to keep the two activities separate: teaching in colleges and research in special institutes. If complements, then teaching and research should be kept together in universities, and rewarding each will improve the other. We do have examples of each kind: in the U.S. universities combine teaching and research, in France the universities are teaching mills and research is carried out in institutes with complicated acronyms like INSEE and CEPREMAP. I think comparison of outcomes of the two suggests that, on the whole, teaching and research are complements.

A related implication pertains to corruption in getting various permissions from government agencies to launch an investment or construction project. The investor needs all the permits; therefore they are all perfect complements. They should be assigned to just one agency. In other words, there should be “one-stop shopping” for permits. Even if corruption is unavoidable, this system will be less corrupt. If permits are controlled by separate agencies, each one fails to take into account the fact that when it increases its corrupt demand, that raises the cost of the whole bundle of permits, thereby decreasing the demand for them and hurting the proceeds of the other agencies that control other permits. When they are all together, they will internalize this externality. They will all lower their rates, and in the process increase business so far that their total revenue will increase! And each investor will pay less, so they will also be better off. The restructuring will be a Pareto improvement. This is a well-known insight from industrial organization: firms as well as customers fare better if complementary goods are sold by a monopolist, rather than by separate oligopolists.<sup>xiii</sup> This idea of one-stop shopping for all permits is practiced by several American states and by countries like Turkey. I understand that it had been tried in India with only mixed success, but believe it deserves more careful consideration. The key problem may be that too many

branches of the government have the power to insist on their separate licensing authority and cannot be corralled into the single shop.

Organizations that implement public policy differ from many other agencies in one crucial respect: they are responsible to multiple principals, not just one. Wilson (1989), in his masterly study of government bureaucracies, highlights this multi-principal aspect (albeit not in the economic terminology of mechanism design). In the public arena, not just the government of the day, but also the opposition, the state governments, the courts, NGOs, media, and several others are in a position to incentivize and influence the actions of agencies. These incentives, positive and negative, are not monetary, but take other forms including persistent pressure, public praise and shame. What effect does the presence of multiple principals with different interests have? Mainly, it weakens the aggregate power of incentives, as each principal tries to offset the incentives offered by others (Dixit 1996, 2002). That can hurt the agency's actions and outcomes adversely. But it can also have fortuitous beneficial effects. With less powerful external incentives, the agents are freer to pursue their own agendas. If their priorities are better aligned with social welfare than those of their multiple conflicting principals, the outcome may be better for society. Indeed, I think we have seen this in action for the last two decades in India. Well-trained and professional civil servants and administrators have pursued broadly sensible and consistent economic policies despite large swings in political conditions. This may be because none of the multiple principals can dominate the others sufficiently to bend the agency in his preferred direction.

Wilson (1989, pp. 299-300) draws an interesting contrast between two different systems of policymaking:

“Policy making in Europe is like a prizefight: Two contenders, having earned the right to enter the ring, square off against each other for a prescribed number of rounds; when one fighter knocks the other one out, he is declared the winner and the fight is over. Policy making in the United States is more like a bar room brawl: Anybody can join in, the combatants fight all comers and sometimes change sides, no referee is in charge, and



the fight lasts not for a fixed number of rounds but indefinitely or until everybody drops from exhaustion.”

In this respect, the Indian political process seems closer to the U.S. than to Europe; China appears to be too far at the other extreme. Each country needs find the right compromise.

#### BENEFITTING FROM BAD GOVERNANCE!

Most of the research, and most of the recommendations, on governance deal with the question of how to improve its quality. However, bad governance can create one advantage for those living under it. Firms and people who have learned to cope with one system of bad governance can transfer that experience more quickly to other systems with bad governance. Even though the two systems may differ in detail, enough broad similarities exist, and an awareness of what needs to be done is a good head-start to actually doing it.

For example, if firms cannot rely on the courts for contract enforcement, they develop networks that disseminate information about potential partners' history of honesty and establish mechanisms for punishing miscreants, thus achieving relation-based informal governance. When such a firm seeks to invest in another country where contract enforcement is poor, it will begin by exploring the networks there, and join them using local partners or ethnic connections. It will not plunge in and start dealing with strangers. If it needs to bribe, it will have a better idea of how to set about it; there is considerable art involved in successful bribery. Such advantages may offset the technological and managerial disadvantage the firm may suffer in competition with other firms from more advanced countries.

Experience in coping with bad governance may help explain the surge in South-South foreign direct investment (FDI) over the last three decades. Considerable theoretical and empirical support for this idea is building up; some of it is reviewed in Dixit (2011, sec. 3.3). In its recent survey of business in India, The Economist magazine said: “if you can make money in India you can make it

anywhere.”<sup>xiii</sup> China’s direct investments in Africa provide further examples of successful transfer of experience of coping with poor governance.

## CONCLUDING REMARKS

In this paper I have used some simple and basic ideas from economic theory to give useful suggestions for the reform of economic governance institutions in developing countries. I hope this contributes to continued thinking and research on this task, which is of primary importance for their continued development to and past middle-income levels. Economists from these countries, with their advantage of local knowledge, are best placed to conduct such research, and I look forward to the results.

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## NOTES

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<sup>i</sup> North (1990, 1994), Williamson (1985, 1996), Ostrom (1990) and others have emphasized the importance of formal and informal institutions for achieving good economic performance and growth. Barzel (1997), Libecap (1989) and others study how these institutions, especially non-state bottom-up ones, evolve and function. For an overview, further work, and some formal modeling see Dixit (2004, 2009). Empirical analyses, with discussion and treatment of issues like identification and reverse causation, include Knack and Keefer (1995), Rodrik, Subramanian and Trebbi (2004). Keefer (2004) has surveyed this work. More recent surveys and contributions include Ugur and Sunderland (2011). See Glaeser, La Porta, Lopez-De-Silanes and Shleifer (2004) for the contrary view that growth in poor countries starts because of good policies, often initiated by dictators, and that improvement of their institutions comes later.

<sup>ii</sup> Notice that even in the best of countries, governance is not 100% perfect in all respects. However, matters have improved dramatically since Hamlet's time: now almost nothing is rotten in the state of Denmark!

<sup>iii</sup> For more on this theme, see Rodrik (2007).

<sup>iv</sup> See <http://www.trans-lex.org/944000> .

<sup>v</sup> Therefore in reality there is no such thing as riskless lending or taking riskless interest; de facto all finance is "Islamic finance" where the lender shares the borrower's risk in one form or another. It may be better for all concerned to recognize this explicitly, and always try to design the optimal contracts in such a mixed mode of finance from the outset, instead of leaving debt renegotiation to ad hoc procedures after a crisis arises. Then all parties can make better plans, knowing in advance how situations of crises will be resolved.

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<sup>vi</sup> For a similar list of desiderata of political institutions more generally, see Keohane (2001, p.3).

<sup>vii</sup> See World Justice Project (2010), and various indices reported on sites such as <http://www.transparency.org/> and <http://info.worldbank.org/governance/wgi/index.asp> .

<sup>viii</sup> See Dixit (2004, 2009) for overviews and theoretical modeling of some formal governmental, informal social, and mixed institutions of governance.

<sup>ix</sup> See [http://en.wikipedia.org/wiki/Better\\_Business\\_Bureau](http://en.wikipedia.org/wiki/Better_Business_Bureau) for a discussion of these and other criticisms.

<sup>x</sup> “Greenspan vs. the Greenspan Doctrine,” by Jon Hilsenrath, *The Wall Street Journal*, February 17, 2009.

<sup>xi</sup> For example Holmström and Milgrom (1991), Dixit (1996, 2002).

<sup>xii</sup> See Fellner (1949). If the complementary goods are vertically related, the same idea is conveyed in the statement that a monopoly avoids double marginalization. Shleifer and Vishny (1993) applied this to the analysis of corruption.

<sup>xiii</sup> “Adventures in Capitalism,” special report on business in India, *The Economist*, October 22, 2011.