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The New Comparative Economics

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## The New Comparative Economics<sup>1</sup>

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## Abstract

In recent years, comparative economics experienced a revival, with a new focus on comparing capitalist economies. The theme of the new research is that institutions exert a profound influence on economic development. We argue that, to understand capitalist institutions, one needs to understand the basic tradeoff between the costs of disorder and those of dictatorship. We then apply this logic to study the structure of efficient institutions, the consequences of colonial transplantation, and the politics of institutional choice.

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## I. Introduction.

The traditional field of comparative economics deals mostly with the comparison of socialism and capitalism<sup>2</sup>. Under socialism, the principal mechanism of resource allocation is central planning. Under capitalism, this mechanism is the market. Comparative economics, which dates back at least to the discussions of market socialism in the 1930s, asks under what circumstances either the plan or the market delivers greater economic efficiency and equality.

By the time socialism collapsed in Eastern Europe and the Soviet Union, this question lost much of its appeal. It was clear that socialism produced misery and inefficiency – not to mention mass murder by the communist dictators who practiced it. Capitalism, in contrast, produced growth and wealth. With capitalism triumphant, is comparative economics dead?

The answer, we argue in this paper, is NO. Traditional comparative economics has evolved into a new field. This field shares with its predecessor the notion that by comparing alternative economic systems, we can understand better what makes each of them work. But it sees the key comparisons as being those of alternative capitalist models that prevail in different countries. Each capitalist economy has many public and private institutions. These institutions function to choose political leaders, to secure property rights, to redistribute wealth, to resolve disputes, to govern firms, to allocate credit, and so on. Political economy over the last two centuries, as well as recent empirical research, demonstrate that these institutions differ tremendously and systematically among countries, with significant consequences for economic performance. The analysis of these differences is the subject of the new comparative economics.

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<sup>2</sup>This field has its own category in the *Journal of Economic Literature*, called Economic Systems. The subcategories are capitalist systems, socialist systems, socialist institutions, other economic systems and comparative economic systems.

In thinking about these issues, it is best to start from first principles. Since the days of the Enlightenment, economists agreed that good economic institutions must secure property rights, enabling people to keep the returns on their investment, make contracts, and resolve disputes. Such security encourages people to invest in themselves and in physical capital, and thereby fosters economic growth. As Smith [1776] wrote, “in all countries where there is tolerable security [of property], every man of common understanding will endeavor to employ whatever [capital] stock he can command... In those unfortunate countries... where men are continually afraid of the violence of their superiors, they frequently bury and conceal a great part of their [capital] stock ... in case of their being threatened with any of those disasters to which they consider themselves as at all times exposed.”

But there are two sides to the security of property rights. On the one hand, investment must be secured – typically by the government – from the expropriation by one’s neighbors: thieves, competitors, or tort-feasors. Hobbes (1651) considered controlling private disorder – the war of all against all – to be the central concern of the state. The problems of disorder – crime, ethnic violence, squatter takings, bribery, investor expropriation, and so on – continue to plague modern developing countries. On the other hand, a government capable of protecting property against private infringement can itself become the violator and thief. Smith refers to the violence from “superiors;” Montesquieu (1748) is even more explicit: “Great enterprises in commerce are not found in monarchical, but republican governments... An opinion of greater certainty as to the possession of property in these [republican] states makes [merchants] undertake everything... Thinking themselves sure of what they have already acquired, they boldly expose it in order to acquire more... A general rule: A nation in slavery labors more to preserve than to acquire; a free nation, more to

acquire than to preserve.” In Enlightenment thinking, a crucial aspect of securing property rights is the control of dictatorship.

A fundamental problem of institutional design is the conflict between the twin goals of controlling disorder and dictatorship. Hobbes, most fearful of disorder, favored absolutism, but subsequent writers recognized that extreme solutions are generally suboptimal. The framers of the U.S. constitution realized that dealing with disorder and localism through a more powerful central government directly conflicts with the objective of restraining the sovereign (Hamilton, Madison, and Jay 1788). This concern with institutional design continues in modern writing, most importantly in institutional economics (Hayek 1960, Olson 1965, 2000, Demsetz 1967, North 1981, 1990, North and Weingast 1989) and public choice (Buchanan and Tullock 1962). In addition, empirical studies confirm the close relationship between good institutions and economic development (De Soto 1989, De Long and Shleifer 1993, Besley 1995, Easterly and Levine 1997, 2003, Knack and Keefer 1995, Acemoglu et al. 2001, Rodrik et al. 2002).

The interest in institutions revived with the collapse of socialism, and the transition of the economies in Eastern Europe, the former Soviet Union, and China to capitalism. The transition experience has been diverse. Many countries of Eastern and Central Europe, especially Poland, Slovenia, Hungary, and the Czech Republic, successfully established both secure democracies and many of the legal and regulatory institutions of capitalism during the 1990s. They grew rapidly, and are expected to fully integrate into Europe over the next several years. Countries further East, such as Romania and Russia, also moved to establish democracies and market institutions, but their experience has been more complex. Some of the Asian countries, from Kazakhstan to China, did not embrace democracy, but undertook significant economic reforms and grew, in China’s case

spectacularly. Finally, several transition economies, including Cuba, Belarus and many countries of Central Asia, did not reform and stagnated.

Early discussions of the transition experiences focused on the speed of reforms – big bang versus gradualism – as a crucial determinant of performance. Although it is now clear that the absence of reform – as in Belarus and Cuba – is associated with both economic and political stagnation, the emphasis on speed turned out to be excessive. The important differences among countries had more to do with the effectiveness of the newly created institutions (Murrell 1995). The countries of Central Europe succeeded in creating successful institutions of both democracy and a market economy. Russia – having moved as fast or faster on many of its reforms – also established a successful democratic government, but faced greater problems of corruption and capture, and began growing only recently.

These divergent experiences raised many questions. Some of them dealt with controlling disorder. How much government ownership is desirable? Poland, the Czech Republic, and Russia privatized extensively; China retained large state industries, yet grew the fastest. How much should governments regulate? Transition saw both successful regulation and degeneration of regulation into corruption and selective abuse of new business (Frye and Shleifer 1997, Hellman, Jones, and Kaufmann 2003, McKinsey 1999). How much should the government fight disorder at all? Many writers saw public institutions as having limited use, and stressed private orderings as the means of securing property and contract (McMillan and Woodruff 1999, Johnson, McMillan, and Woodruff 2002, Allen, Qian, and Qian 2003, Murrell 2003).

Other questions focused on dictatorship. For starters, is democracy the best political system for economic reform or is dictatorship efficient when radical change is required? China's economic

success under communism, contrasted with the difficulties of Yeltsin's democracy in Russia, animated the advocates of one party rule; the successes of democracies of Central Europe pointed in the opposite direction. Within democracies, do reforms proceed better under divided or consolidated governments? Many economists assumed that consolidated government is better for reforms, yet here again, the deeply divided governments of Central Europe had the most success (Hellman 1998). Is a federal structure desirable from the viewpoint of economic transformation? Scholars of China credited its federalism and resulting competition among regions with the success of reforms (Jin and Qian 1998, Roland 2000); scholars of Russia saw its federalism and the resulting conflict between the regions and the center as a key obstacle to stability (Shleifer and Treisman 2000, Blanchard and Shleifer 2001, Zhuravskaya 2000).

What can one make of these questions? First, the standard economic questions of market failure, and inefficiencies associated with it, have played virtually no role in the central debates of transition. Rather, the central issues have all dealt with property rights: how these rights can best be secured against both public and private expropriation? Second, we see in all these questions a common tradeoff. On the one hand, there is the objective of controlling disorder, that pushes toward greater state intervention. On the other hand, there is the goal of controlling dictatorship, that pushes against state power. In the rest of the paper, we explore this tradeoff.

To this end, we present a framework describing the tradeoff between dictatorship and disorder, and apply it to the problem of social control of business. We argue that the four common strategies of such control: private orderings, private litigation, regulation, and state ownership, can be thought of as points on the institutional possibility frontier, ranked in terms of increasing powers of the state. These strategies are associated with progressively diminishing social costs of disorder,

and progressively rising social costs of dictatorship. We use this framework to analyze efficient institutional choice, and to argue that it provides useful empirical predictions as well as guidance for reform.

But the efficiency perspective is not the only way to think about institutional choice. A key reason for institutional inefficiency is the transplantation of institutions through conquest and colonization. Many countries have inherited their legal systems. An institution which in the origin country respects the delicate tradeoff between dictatorship and disorder may not, once transplanted, remain efficient. This view of colonial transplantation may shed light on the amazing consistency with which a given country regulates different activities, as well as on some institutional pathologies. In addition, as both the Marxist and the public choice literature have long recognized, governments choose policies and institutions to benefits themselves – to stay in power and to get rich. The politics of institutional choice may also explain the inefficiencies.

We describe our framework in Section II and illustrate it in Section III. Section IV focuses on transplantation, and Section V on politics. Section VI concludes.

## II. Basic Framework.

The two central dangers that any society faces are disorder and dictatorship. By disorder we mean the risk to individuals and their property of private expropriation in the form of murder, theft, violation of agreements, torts, monopoly pricing, and so on. Disorder, in this framework, is also reflected in private subversion of public institutions, such as courts, through bribes and threats, which allows private violators to escape penalties. By dictatorship we mean the risk to individuals and their property of expropriation by the state and its agents in the form of murder, taxation,

violation of property, and so on. Dictatorship, in this framework, is also reflected in expropriation through – rather than just by – the state, as with the use of regulators to eliminate entry by competitors. Some phenomena, such as corruption, are reflections of both disorder and dictatorship: in so far as individuals pay bribes to avoid penalties for harmful conduct, corruption is a reflection of disorder, but in so far as officials create harmful rules to collect bribes from individuals seeking to get around them, corruption is a cost of dictatorship.<sup>3</sup>

Institutions function to control the twin dangers of dictatorship and disorder. We focus on a fundamental tradeoff inherent in such control: a state that has enough powers to control disorder also has enough for dictatorial abuse.

Figure 1 – the basic building block of our analysis – depicts what we call the Institutional Possibility Frontier (IPF) for a society or a sector within it. On the x-axis are the social losses from a higher level of dictatorship (as opposed to gross amounts of such activities as taxation and government expropriation), measured relative to a world with perfect property rights. On the y-axis are the social losses from a higher level of disorder, again measured relative to a perfect property rights benchmark. We measure the costs of dictatorship and disorder in the same units of “social losses” to think about the tradeoff. The IPF reflects the institutional possibilities of the society: how much disorder can be reduced with an incremental increase in the power of the state. As in all standard neoclassical theory, the IPF is convex to the origin. In our framework, an institution – such as a legal or a regulatory system – is a point on the IPF.

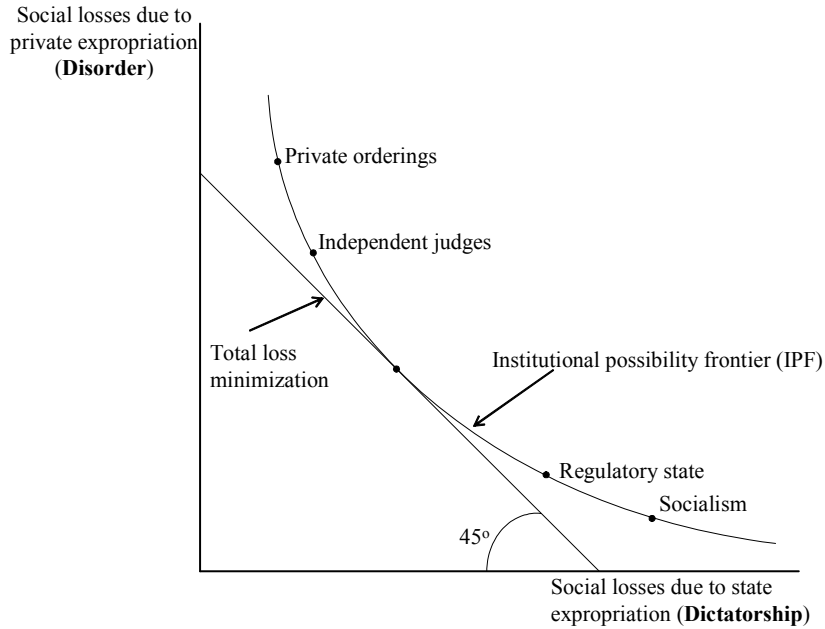
In thinking about institutions, economists usually distinguish between written rules and their

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<sup>3</sup>Our discussion of dictatorship and disorder is related to the literature on rent-seeking and corruption (Tullock 1967, Posner 1974, Shleifer and Vishny 1993, Ades and DiTella 1997).

enforcement. In our framework, this separation disappears: a rule comes with its own enforcement properties, reflected in the equilibrium degree of dictatorship and disorder arising

**Figure 1: Institutional possibilities**



when this rule is used. If Russia regulates its monopolies through an anti-trust agency, there will be a certain residual amount of market failure, the equilibrium disorder, given by the waste from actual monopolists escaping the law and exercising their market power, as well as from their bribing the regulators to let them do so. There will also be a certain amount of public abuse of the private sector, the equilibrium dictatorship, associated with monopolists using the regulator to restrict entry by competitors, as well as from the agency's officials charging non-monopolists bribes in exchange for agreeing not to harass them.

The downward sloping 45 degree line in Figure 1 holds constant the total social costs of dictatorship and disorder. Its point of tangency with the IPF is the efficient institutional choice for

a given society or a sector within a society. In much of our discussion, we focus on the efficient institutional choice for a given IPF. Efficient institutions could evolve from democratic pressures (Wittman 1989), from the influence of growth-seeking interest groups such as merchants (DeLong and Shleifer 1993), from a Coasian negotiation among the members of the elite, such as the Magna Carta or the American Constitutional bargain (Becker 1983), or from a long term evolutionary process described by Hayek (1960). Moreover, looking at efficient institutional choices does not mean that, in equilibrium, the society eliminates the problems of dictatorship and disorder. It does not. Consistent with Coase (1960), even the most efficient institutional structure retains residual levels of both dictatorship and disorder.

The shape and the location of the IPF -- and hence the efficient choice -- varies across activities within a society, as well as across societies.<sup>4</sup> An activity that involves repeated interactions among participants of roughly similar resources, and with little technological change, such as diamond trading, can achieve order with little dictatorship (Bernstein 1992). In contrast, an activity like security issuance, involving players with few repeated interactions and massive inequalities of power, is vulnerable to much more disorder for a given level of police.

Looking across societies, the differences loom even larger. The institutional possibilities of modern Sweden, or even China, are far superior to those of Albania or Congo. Sweden can pursue

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<sup>4</sup>Empirical growth studies generally confound the location of the IPF and the choice of a point on it under the rubric of “institutions,” but for us it is important to draw the distinction. In these empirical studies, “institutions” are measured with a variety of objective and subjective assessments of institutional quality of a country, such as law and order, risk of government expropriation, rule of law, corruption, efficiency of the judiciary, or some combination of these variables (Easterly and Levine 1997, 2003, Hall and Jones 1999, Kaufmann, Kraay, and Zoido-Lobaton 2002). These variables are highly correlated with each other, and have proven to be strong predictors of per capita income, economic growth, and many other “good” outcomes, but it is not entirely clear what they measure conceptually.

either extreme laissez-faire policies or toy with socialism and still achieve decent outcomes, Albania can choose a perfect balance of dictatorship and disorder for its IPF, but property rights would remain insecure. For lack of a better term, we refer to location of the IPF as “civic capital,” with the idea that societies with more such capital, and an IPF closer to the origin, are better capable of achieving cooperation among their members. We use the term “civic capital” rather than social capital because we have something similar but broader in mind. We stick with the idea of capital because investments in civic capital pay off in the medium run.

Recent historical research has made progress in understanding the determinants of civic capital. Landes (1998) continues the great tradition of stressing the influence of culture. Easterly and Levine (1997) and Alesina, Baqir and Easterly (1999) show how ethnic heterogeneity, and the resulting ethnic strife, reduce institutional quality. Diamond (1997) and Engerman and Sokoloff (1997, 2002) stress the role of factor endowments and the physical environment in shaping – and limiting – the institutional opportunities of a society. For instance, the environment of Latin America, unlike that of North America, was most hospitable to large scale agricultural technologies that bred significant economic and social inequalities, causing a long-lasting damage to the regions’ institutions. Acemoglu, Johnson, and Robinson (2001) argue that the mortality of European settlers shaped settlement patterns and institutional outcomes. Putnam (1993) maintains that the long run history of cooperation in a community -- its social capital -- determines the ability of its members to cooperate in the production of public goods.

But there are some other, more prosaic, determinants of civic capital. Technology of production matters. When the scale of production and the pace of interaction among individuals rise, the opportunities for private expropriation expand, moving the IPF out. The technology of

government repression – the efficiency of tax extraction and the monopoly on power – influence both the location and the shape of the IPF, because they determine how much dictatorship is needed to reduce disorder both on average and at the margin. Last but not least, the level of human capital in the society is itself likely to determine the location of the IPF, as better educated and informed people may be more likely to solve problems without violence.

Admittedly, civic capital is a somewhat vague concept, but many aspects of it have been measured. We have already referred to the measurement of historical influences, which are predetermined for many policy choices. Other aspects of civic capital, such as human capital, technology, or inequality, can be changed in the medium run through public investments or large interventions, such as land reform. For many reforms that economists focus on, however, including social control of business, the location of the IPF is fixed in the short run. For the analysis of such reforms, civic capital is a constraint rather than a choice.

To think about the IPF and institutional choices in more concrete terms, consider the problem of social control of business. Suppose that “the society” wishes to reduce disorder from monopoly pricing, torts, predatory tactics, etc. There are four distinct strategies of such control, involving ever growing powers of the officials vis-a-vis private individuals: market discipline, private legal action through courts, public enforcement through regulation, and state ownership. They are shown as points on the IPF in Figure 1. These four strategies are not mutually exclusive: competition and regulation often operate in the same market, as do private litigation and public regulation. Moreover, intermediate strategies of social control of business, such as private litigation to enforce public rules, are available. Nonetheless, these four categories provide a useful analytical classification.

To illustrate these categories, take the example of social control of securities issues. Suppose that the society – through its institutions – has an interest in having broad and liquid securities markets and, to this end, deems it desirable that firms issuing equity disclose accurate information about their circumstances. The society has four choices.

First, it can rely on the incentives of issuers themselves, or of their underwriters, to disclose the truth about the securities because, to raise funds in the future, they need to establish a reputation for credibility. This is the market discipline solution.

Second, the society can rely on private suits by buyers of securities who feel that they have been cheated by the issuers, under the general doctrines of contract or tort. For this, the society needs a court and a judge. The question for the court is whether the issuer disclosed inaccurate information or, alternatively, negligently failed to provide material information.

Third, the society can designate a public regulatory agency, which mandates what should be disclosed by security issuers, inspects their books and disclosures, and penalizes issuers and underwriters who break the regulations. Between private litigation and full-scale regulation, the regulatory agency can establish the rules for security issuance, but leave the enforcement of these rules to private litigation by the wronged investors.

Fourth, the society can nationalize security issuance. A company wishing to raise capital would turn over the inspection, disclosure, and sale of securities to the state. These are the four basic institutional strategies for the enforcement of good conduct.

These four basic strategies differ in the degree of public control. With competition and private orderings, there is basically no public involvement. With courts, there is a role for impartial judges enforcing the rules of good behavior. These rules do not even need to come from legislation,

but may instead derive from custom or from judge-made common law. Even so, there is a public agent – the judge – who has at least some decision-making authority. With regulators, control by the state rises sharply. The state now writes the rules, inspects the product before it is sold, and possibly penalizes sellers for delivering a bad product. Both the scope of government activity, and its centralization, are greatly increased relative to the judges. Finally, with state ownership, government takes complete control over an activity.

From the perspective of the tradeoff between dictatorship and disorder, the principal strength of market discipline as a method of enforcing good conduct is that it is free of public enforcers. There is no possibility of politicization of rules of conduct, of corruption, of costly and delayed enforcement of rules, of random or compromised choice of one competitor over another. But market discipline often fails to control disorder. Market participants use their economic, political, or social resources to damage their customers and rivals, relying on methods ranging from deception to predatory pricing to monopoly pricing to social exclusion to outright theft or violence. One man's peaceful private orderings become another man's death in the hands of the mafia. When market discipline can successfully control disorder and avoid Hobbesian anarchy, it works best because it minimizes the social costs of dictatorship. As a corollary, any case for public intervention relies crucially on the presumptive failure of market discipline to control disorder.

This case for the effectiveness of private orderings and market discipline is often compelling. Neighbors resolve disputes among themselves, without any government intervention, because they need to get along with each other over long stretches of time (Ellickson 1991). Industries form associations that assure quality for consumers, and penalize cheaters among themselves to assure that consumers continue to patronize the industry (Greif 1989, 1993, 1994, Bernstein 1992).

Families, cities, and ethnic groups establish reputations in the marketplace, and penalize reputation-threatening misconduct by their members. To the extent that market discipline can control disorder, regulation, or even courts, are unnecessary.

But this is far from always being the case. Market pressures may not get rid of all monopolies. Employers may under-invest in safety and then blame accidents on an injured worker's own carelessness (Fishback and Kantor 2000). A fraudulent stock issue can separate investors from their money very quickly, undermine confidence in markets, and run off with the cash. In these instances, to control disorder, societies may efficiently accept a higher level of government intervention and dictatorship.

The traditional libertarian response to these problems is to move one notch toward more dictatorship by turning to the enforcement of good conduct through private litigation over contracts and torts. Injured employees can sue their employers for harm. Investors can sue issuers and underwriters for damages when they believe that representations about securities were false or incomplete. Ideally, a judge would recognize quickly whether investors have been misled, and compel the issuer to compensate investors for their losses. Such judicial enforcement of contracts and torts is seen by libertarians as a sufficient guarantee of security of property.

Private litigation has many advantages. In principle, such litigation is of no special interest to the government, and hence disputes can be resolved apolitically, with no favors to influential parties. Judges may also develop expertise in contract enforcement (as well as in handling tort cases), and hence address problems efficiently and expeditiously. This is what Coase (1960), Nozick (1974), and Posner (1985) have in mind in making the case for courts.

The reality of litigation is, unfortunately, not so perfect, and the tradeoff between dictatorship

and disorder is helpful for thinking about courts as well. As with private orderings, the powerful and not the just often get their way in court (Galanter 1974). Some mechanisms of influencing courts, such as hiring good lawyers, delaying proceedings, and (in some instances) seeking political help, are entirely legal. But judges are also bribed with cash, benefits, or promises of promotion, as well as threatened with violence if they do not favor the strong (Dal Bó, Dal Bó, and Di Tella 2002). When the rich and the politically connected influence the path of justice, litigation over contracts and torts cannot be counted on for enforcing socially desirable conduct (Glaeser, Scheinkman, and Shleifer 2003).

A common way of protecting judges from influence is to formalize laws and procedures through codes, so as to minimize judicial discretion and the potential for subversion. Such strategies can be thought of as a move along the IPF, as they reduce disorder but also offer the state more control over the outcomes of litigation. A related mechanism for controlling private subversion of courts is to make judges employees of the state, whose career concerns protect them from succumbing to outside influence. But as judges become more dependent on the state, the risk of politicization of their decisions rises, and so do the social losses from dictatorship.

This brings us to the third strategy of enforcing good conduct, government regulation. Regulation has been an anathema to libertarians such as Nozick (1974), who see a sharp contrast between the enforcement of rules by judges and that by regulators. But in fact, the change to a higher level of dictatorship is incremental, and there is no profound conceptual distinction between litigation and regulation. The libertarian distinctions miss Coase's (1960) realization that the costs of enforcement shape the optimal institutional choice.

To make this continuity clear, note that a step short of full-fledged public enforcement, there

is an important intermediate strategy, namely private enforcement of public rules. The government can create rules governing private conduct and then leave their enforcement to private litigation. Private enforcement of such specific statutes through litigation is often considerably cheaper than that of contracts or torts. It may be efficient, for example, for the government to specify appropriate safety standards but to let workers or consumers sue when they feel the standards are violated. Likewise, the government can mandate specific disclosures by a company issuing shares, but then leave litigation to investors. It may be cheaper for investors to establish in a trial that the company has failed to reveal specific information whose disclosure was mandated by law, than to prove the issuer's negligence in the absence of a statute.

Private enforcement of public statutes addresses a number of problems of disorder inherent in pure litigation. First, the burdens on the courts and the plaintiffs of proving liability (or the lack thereof) fall considerably when the statutes describe precisely what facts need to be established to do so. Second, subversion of judges becomes more difficult when they lose discretion. It may be relatively easy to convince a judge – by persuasion or bribery – that a security issuer who concealed important information from investors is not liable when there are no specific rules as to what needs to be disclosed. It is much harder to convince the same judge when the law states specifically what must be disclosed. Perhaps for these reasons, private enforcement of public rules is a highly efficient strategy of enforcing good conduct in some situations (Black and Kraakman 1996, Hay and Shleifer 1996, Hay, Shleifer and Vishny 1998).<sup>5</sup>

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<sup>5</sup>La Porta, Lopez-de-Silanes, and Shleifer (2002b) show that this is a key strategy for enforcing good conduct in security issuance in many countries. Barth, Caprio, and Levine (2003) show that private enforcement of public disclosure rules is a key strategy of bank supervision.

At the same time, the creation of public rules – even rules that are enforced privately – raises the risks of dictatorship. Such rules can be used to expropriate politically weak and to favor the politically strong. Mandatory safety precautions in factories, mines, and meat-packing plants during the progressive era in the U.S. at the beginning of the 20<sup>th</sup> century are sometimes interpreted as an attempt by large established firms to restrict entry by smaller rivals by raising these rivals' costs of regulatory compliance (Libecap 1992, Coppin and High 1999).

Compared to the enforcement strategies described above, public regulation has a number of advantages in controlling disorder. First, unlike judges, public regulators can be expert and motivated to pursue social objectives in specific areas. This, indeed, has been the principal argument for public regulation of securities markets (Landis 1938, Johnson, Glaeser, and Shleifer 2001). A regulator can become expert, for example, in what constitutes material omission from a prospectus, present market participants with specific rules, and then enforce them by imposing its own sanctions or by convincing courts to adopt its rules. Second, to the extent that regulators are empowered to complete the law, they may have an enforcement advantage relative to judges by acting preemptively (Pistor and Xu 2002). Third, because regulators can be incentivized by the sovereign to enforce social policy, they can in principle be much more difficult to subvert than the disinterested judges with either persuasion or bribes (Glaeser and Shleifer 2003). These differences render public enforcement more efficient than private enforcement in some cases.

Alas, public regulation obviously has problems, the key one being public abuse of market participants by the officials who are either pursuing their own political interests or are captured by a particular group, including the regulated industry itself (Stigler 1971). Although motivated regulators might be more difficult to subvert than judges, regulated industries have developed a

range of techniques to turn regulation into a mechanism of protecting industry rents rather than public welfare. The risks from dictatorship clearly rise as those from disorder decline.

The basic implication of our theory is that regulation is only necessary when the level of disorder is too high for private orderings and even courts to deal with successfully. The case for regulation is most compelling when the problem of inequality of weapons between private parties involved in a transaction is severe. Securities issuance is one instance; workplace safety is perhaps another. In contrast, entry of new firms into competitive markets is unlikely to require regulatory control (De Soto 1989, Djankov et al. 2002). Most regulations of competitive labor markets are likewise difficult to justify on efficiency grounds (Botero et al. 2003).

Finally, in some situations, nothing short of government ownership can eliminate disorder. If monopolies cannot be tamed by competition or regulation, if quality is essential but cannot be assured except with full state control, if public safety is jeopardized – then there can be a plausible case for state ownership. Hart, Shleifer and Vishny (1997) argue that prisons might be properly publicly- rather than privately-owned because the risk that private jailers mistreat inmates is too high. This is so because inmates have few legal rights and cannot count on the market, the courts, or even the regulators to protect them. Likewise, the military and the police tend to be state-controlled because the likelihood of disorder from private control is too high. The case for the “state monopoly on arms” is just a reflection of a particular area where the tension between dictatorship and disorder is resolved by going to an extreme.

Although in some instances the case for government ownership as a means of dealing with disorder is compelling, state ownership has the obvious problems of dictatorship, illustrated by the miserable performance record of public enterprises and the benefits of privatization (Lopez-de-

Silanes 1997, La Porta and Lopez-de-Silanes 1999, Megginson and Netter 2001, Djankov and Murrell 2002). The failure of state socialism as an economic system reveals most dramatically the consequences of dictatorship taken to an extreme, in which all economic problems are solved to maintain political control by the communist party (Kornai 1992).

In summary, the framework presented in Figure 1 enables us to discuss systematically the alternative forms of social control of business. As a consequence, it may provide some useful input into thinking about efficient institutional choices. In the next section, we put the model to work and examine three episodes of institutional design. In the following two sections, we move away the assumption of efficiency, and examine alternative views of institutional choice.

### III. Applications.

We examine three applications of the basic framework: the divergence between France and England in the 12<sup>th</sup> and 13<sup>th</sup> centuries in their choices of legal systems, the rise of the regulatory state in the progressive era U.S., and post-communist transition. In all three instances, we focus on efficient institutional choice given the institutional possibilities of a country.

#### *Legal Origins*

In the 12<sup>th</sup> and 13<sup>th</sup> centuries, England and France established the foundations of their modern legal systems. These systems took rather different forms. England developed a system of common law, characterized by fact finding by juries, relatively independent judges, infrequent appeals, and the reliance on precedents and judge-made law rather than strict codes in reaching judicial decisions. France, following the Roman tradition, adopted a system of civil law, characterized by fact finding

by state-employed judges, automatic superior review of decisions, and later the reliance on procedural and substantive codes rather than judicial discretion. Over the centuries, some of these differences have been emasculated, others reinforced, but the basic differences among the two legal systems survive to this day.

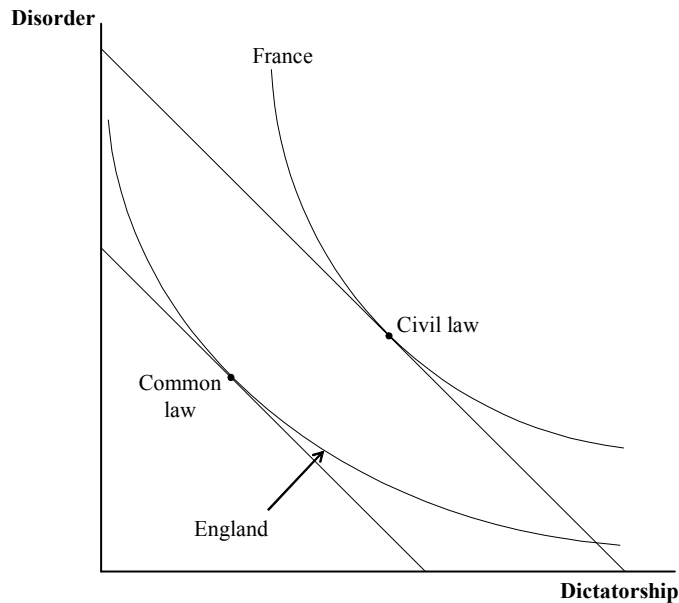
Why did the two systems diverge? Glaeser and Shleifer (2002) argue that a crucial feature of any legal system is its vulnerability to subversion by the powerful (disorder). The greater are the pressures on courts to rule for the strong rather than the just, the more centralization (dictatorship) is needed to counter these pressures. On the other hand, greater centralization raises the cost of dictatorship: sovereigns rule according to their personal preferences and biases rather than the community standards or laws that the jurors follow.

In the 12<sup>th</sup> and 13<sup>th</sup> centuries, France was relatively decentralized and disorderly, with local notables successfully able to subvert all local institutions to their own advantage. England, in contrast, was relatively peaceful and the king maintained control over the entire country. To counter disorder, it was efficient for France to adopt a legal system with higher dictatorship than England, even at the cost of greater scope for sovereign abuse of the law.

Figure 2 illustrates the relevant choices, where we think of the French IPF as a shift out of the English IPF, but also as a tilt that made marginal increases in dictatorship highly productive in reducing disorder. The efficient choice for France was a legal system with a higher level of dictatorship. In equilibrium, France had a higher level of disorder as well, consistent with the notion that its institutional possibilities were less attractive. Glaeser and Shleifer (2002) further show that state employed judges, reluctance to rely on independent jurors, codification of rules and procedures, and nearly-automatic appeals are all complementary aspects of this choice of greater centralization

and dictatorship to counter the problems of disorder.

Figure 2: Legal origins



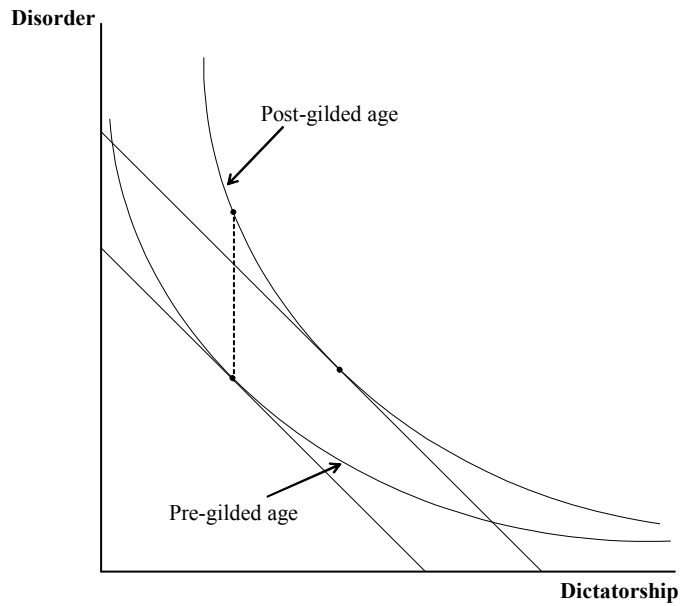
### *The Rise of the Regulatory State*

Before 1900, significant commercial disputes in the United States were generally resolved through private litigation over contracts and torts. Courts ruled on corporate liability in industrial accidents, on anti-competitive practices such as railroad rebates, on safety of foods and medicines, and even on the constitutionality of the income tax. Between 1887, when Congress passed the Interstate Commerce Act, and 1917, when participation in the war put an end to the progressive movement, this situation changed radically. Over thirty years, reformers eroded 19<sup>th</sup> century belief that private litigation was the sole appropriate response to social wrongs. During the progressive era, regulatory agencies at both the state and the federal level took over the social control of

competition, anti-trust policy, railroad pricing, food and drug safety, workplace safety, and many other areas. The regulatory state was born in the United States.

Glaeser and Shleifer (2003) interpret this experience using a model intimately related to the framework of this paper. They argue that the pre-Civil-War United States was a relatively stable country, without great inequality among the potential litigants, so private litigation was an efficient strategy of social control of business (see Figure 3). But massive industrialization and commercialization of the American economy after the Civil War severely undermined courts as the sole institution securing property rights. The rise of railroads and large firms greatly increased disorder: these firms maimed passengers and workers, destroyed their competitors through aggressive and possibly wasteful tactics, occasionally poisoned and deceived customers, and so on. The growth in disorder resulting from the greater scale of enterprise and rising inequality of wealth shifted the IPF of the economy out, rendering the existing system of private dispute resolution inefficient. The robber barons commanded economic and political resources that overwhelmed consumers, workers, or competitors who complained in court. They did so both legally – by hiring superior lawyers, and illegally – by bribing judges and legislators. Figure 3 illustrates the changes in the U.S. economy during the post-civil-war era, as well as the regulatory reform. Technological change shifted the IPF out, but also twisted it so that the reduction in disorder from a marginal rise in dictatorship increased. When courts were subverted but regulations were new and relatively benign, marginal regulation was highly productive. As Figure 3 shows, the efficient institutional choice in the American economy in response to this shift in the IPF called for more regulation to provide the countervailing power to big business.

**Figure 3: Progressive reforms**



Glaeser and Shleifer (2003) interpret the rise of regulation, of litigation over statutes rather than contracts and torts, as well as many other reforms in the U.S. economy during the progressive era, as precisely such a shift toward the newly-efficient system of social control of business. In equilibrium, disorder may well have increased relative to the mid-19th century – this by itself does not imply that the progressive reforms were ineffective. Dictatorship, as noted by Stigler (1971) and his followers, increased as well. The greater power of the state has led to greater benefits of state capture, and more such capture in equilibrium. Still, the reforms have moved the U.S. economy to a better point than it was at in 1880, as much of the evidence on economic and social progress during the reform period indicates.

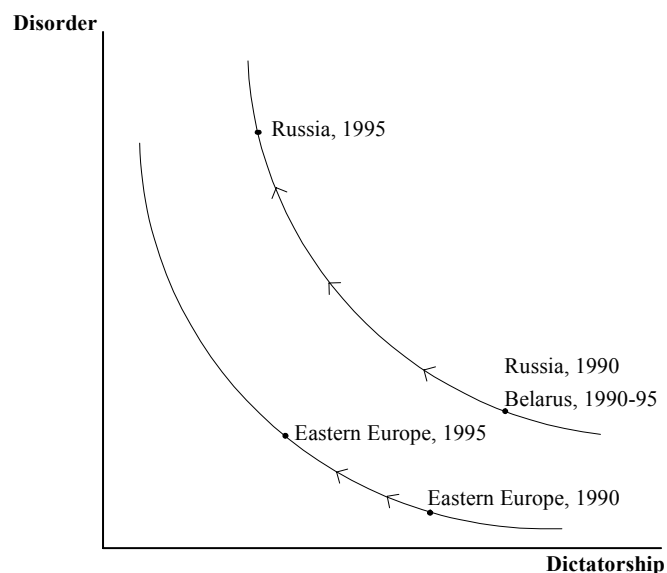
### *Institutions in Transition*

At least some aspects of the transition of Eastern Europe and the Former Soviet Union from socialism to capitalism can be interpreted using our framework. The crucial – though often insufficiently emphasized – aspect of the transition is the collapse of communism, and therefore a sharp decline in dictatorship through most of the region. Figure 4 presents our view of Russia, East European countries, and the FSU non-reformers (with Belarus taken as an example), in the first few years of transition. Two crucial factors separate Russia from FSU non-reformers on the one hand, and from East European reformers on the other. First, Russia has experienced a much more dramatic decline in dictatorship and, consistent with our model, a rise in disorder, than countries like Belarus and Uzbekistan. Second, Russia's IPF is probably less attractive than that of the East European countries and, at the same time, its shift along the IPF was probably greater.

According to Kornai (1992), the communist party is the critical mechanism of keeping economic, political, and social order in socialist countries. Such police order comes at the expense of personal, economic, and political freedom, and as such has enormous human costs, but it is order nonetheless. As the communist control of the Russian economy and society was eliminated by Gorbachev and Yeltsin, so were the mechanisms of keeping order. The immediate benefits of disorder – the free press, the growth of entrepreneurship, the tremendous rise of ties to the rest of the world – were apparent, but so were the costs. The initial impact of the fall of economic dictatorship was extreme economic disorganization (Murrell 1992, Murphy, Shleifer and Vishny 1992, Blanchard and Kremer 1997), but even as markets began to work, the lack of law and order was manifest. The unofficial economy reached perhaps as much as 40% of the total (Johnson, Kaufmann, and Shleifer 1997). The nascent public institutions were subverted by the powerful

through crime, corruption and political influence (Shleifer 1997, Hellman, Jones, and Kaufmann 2003, Sonin 2003). Most importantly, the U.S.S.R. disintegrated and Russia itself – like the U.S. prior to the adoption of its constitution and Argentina today – experienced severe problems of localism, with regional governments undermining both national finances and law and order (Shleifer and Treisman 2000, Zhuravskaya 2000). Russia’s transition can be plausibly described as a sharp move up along its IPF.

**Figure 4: Transition**



This experience can be usefully contrasted with that of non-reforming states, such as Belarus and Uzbekistan, where communist dictatorship was replaced by personal dictatorship, but many of the controlling institutions of the communist state remained intact. These countries still utterly lack freedom, but they also did not suffer as sharp a rise in disorder. Tellingly, Belarus and Uzbekistan retained extremely small unofficial economies, a clear indicator of pervasive state control (Johnson,

Kaufmann, and Shleifer 1997). They also did not experience as large a decline in officially measured output, again consistent with preserving order. On the other hand, these countries failed to reap the benefits of economic transition from communism, and over the decade performed very poorly.

Compared to Russia, Eastern Europe had a more attractive IPF. East European countries lived through a shorter spell of communism, and have, in the cases of the Czech Republic, Hungary, and Poland, rebelled against their Soviet occupiers and local dictators. They had many more independent organizations and, in the case of Poland, an independent Church. They were also more integrated into Western Europe, and from the beginning anxious to join the European community, which imposed rules of cooperation restricting dictatorship and disorder. Compared to Russia (or Yugoslavia), East European countries also did not move as far up along their IPFs, perhaps because they did not face as severe problems of decentralization and localism.

A plausible case can be made that Russia in the 1990s stayed on its institutional possibility frontier. It has moved away from the communist dictatorship, but arguably overshot initially in its institutional change toward too much disorder. Under the Putin presidency, Russia has moved down along its IPF toward reducing disorder, even at the cost of some growth in dictatorship. The more general point suggested by this reasoning is that economic and social change in each country should be considered in light of its own institutional possibilities, rather than some idealized view of perfect law and order.

#### IV. Transplantation.

Although one can explain at least some institutional diversity by focusing on efficient

choices, these are clearly not the whole story. One dramatic deviation from the assumption of indigenous formation of institutions is transplantation. As European powers conquered much of the world in the 19<sup>th</sup> century, they brought with them their institutions, including their laws. A significant portion of institutional variation among countries, especially in legal systems, is accounted for by transplantation (Watson 1974, La Porta et al 1997, 1998, Berkowitz et al 2002).

When the English, the French, the Spaniards, the Dutch, the Germans, and the Portuguese colonized the world, they brought with them many institutions, including language and sports. As we discussed above, there is systematic variation among these institutions in origin countries, shaped by their political economy over the last millennium. England developed a common law tradition, characterized by the independent judges and juries, relatively weaker reliance on statutes, and the preference for contracts and private litigation as a means of dealing with social harms. France, in contrast, developed a civil law tradition, characterized by state-employed judges, great reliance on legal and procedural codes, and a preference for state regulation over private litigation. Germany developed its own civil law tradition, also based in Roman law. There is also a distinctive legal tradition of Scandinavian countries. Finally, and crucially for the 20<sup>th</sup> century, the U.S.S.R. developed a system of socialist law.

Napoleon exported the French legal system during his conquests to Spain, Portugal, and Holland, and through his and their colonial conquests, it was transplanted to all of Latin America, large parts of Europe, North and West Africa, parts of the Caribbean, and parts of Asia. The common law tradition was transplanted by England to the U.S., Canada, Australia, New Zealand, East Africa, large parts of Asia (including India), and parts of the Caribbean. The German legal system was voluntarily adopted by Switzerland, Austria-Hungary, and later Japan, and through

Japan it influenced legal systems of Korea, Taiwan, and China. The U.S.S.R. transplanted its legal system to socialist countries. These channels of both voluntary and colonial transplantation suggest that there might be systematic variation in legal systems among countries.

Some of the initial evidence on transplantation of legal systems, assembled by La Porta et al. (1997, 1998), strongly supports this hypothesis. The authors look at the laws governing the protection of investors – shareholders and creditors – from expropriation by corporate insiders using a sample of 49 countries around the world. They find that, generally speaking, common law countries protect shareholders better than do civil law countries, and especially French civil law countries. They also find that common and German civil law countries protect creditors better than do the French civil law countries. La Porta et al. (1997, 1998) and subsequent studies also show that both legal origin and investor protection are strongly correlated with various aspects of financial development (Demirguc-Kunt and Levine 2001, Johnson et al. 2000, Wurgler 2000, Beck et al. 2003a,b, Friedman, Johnson, and Mitton 2003, La Porta et al. 2000, 2002).

Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002, 2003) and Botero et al. (2003) take these cross-country comparisons further by examining various domains of government regulation, including entry by new firms, judicial procedures in courts, and labor markets. Although the data for each of these studies were collected using different procedures and they cover somewhat different samples of countries, some systematic patterns emerge. Countries appear to have pronounced styles of social control of business intimately related to the legal origin of their laws. In all three areas – entry, courts, and labor – socialist and French legal origin countries regulate much more heavily than do the common law countries. On average, the very same countries that regulate entry, also regulate courts and labor markets, and that these correlations are at least in part

driven by legal origin (see Table 1).

**Table I**  
**Correlations between regulation measures**

The table shows the pairwise correlations of regulation indices across 63 countries. No former or current communist countries are included to avoid spurious correlation. The measures of regulation are: (1) "Employment laws index" which measures the level of protection of labor and employment laws and is formed by the normalized sum of: (i) subindex: alternative employment contracts. (ii) subindex: conditions of employment. (iii) subindex: job security; (2) "Number of procedures to start a business;" which is defined as the number of different procedures that a start-up has to comply with in order to obtain a legal status, i.e., to start operating as a legal entity; and (3) "Court formalism index for the collection of a bounced check" which measures substantive and procedural statutory intervention in judicial cases at lower-level civil trial courts, and is formed by various characteristics in the process such as the need for lawyers and legal justifications in the process, written vs. oral elements, statutory regulation of evidence, control of superior review, engagement formalities for the parties, and the number of independent procedural actions.

	Employment laws index	Number of procedures to start a business
Number of procedures to start a business	0.6168 <sup>a</sup>	1
Court formalism index for the collection of bounced check	0.6083 <sup>a</sup>	0.5944 <sup>a</sup>

a=significant at 1 percent level; b=significant at 5 percent level; c=significant at 10 percent level.

Sources:

"The Regulation of Labor," Harvard University manuscript, November 2002 (Botero, Djankov, La Porta, Lopez-de-Silanes and Shleifer);  
 "The Regulation of Entry," Quarterly Journal of Economics CXVII, February 2002, 1-37 (Djankov, La Porta, Lopez-de-Silanes and Shleifer);  
 "Courts," Quarterly Journal of Economics, forthcoming 2003, (Djankov, La Porta, Lopez-de-Silanes and Shleifer).

The same rankings appear when we look at state ownership. Socialist and French legal origin countries have more government ownership of banks (La Porta, Lopez-de-Silanes, and Shleifer 2002a) and a greater role of state-owned enterprises in the economy (La Porta et al. 1999) than do common law countries. This evidence suggests that transplantation, rather than local conditions, exerts a profound effect on national modes of social control of business, including both state ownership and regulation. This evidence poses a sharp challenge to standard theories of regulation, which emphasize local industry conditions and the power of interest groups, as opposed

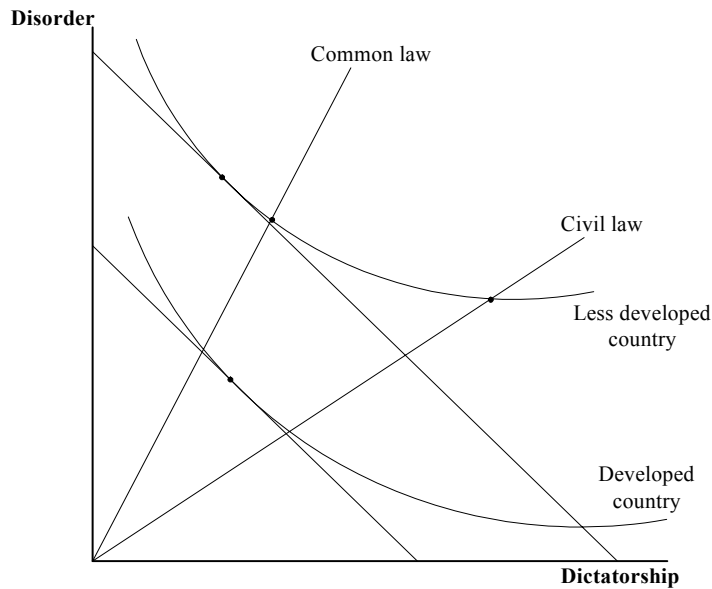
to broad national tendencies, to explain regulatory practice.

The fact that colonial transplantation is such a significant determinant of institutional design suggests that the observed institutional choices may well be inefficient. A legal and regulatory system perfectly suitable for France might yield inefficiently high levels of regulation and state ownership when transplanted to countries with lower civic capital. Likewise, a system of independent courts that works in Australia or the U.S. might fail in Malaysia or Zimbabwe. Can we understand how colonial transplantation can go awry?

Figure 5 applies our theoretical framework to transplantation. We think of a legal system as (roughly) limiting dictatorship and disorder in fixed proportions. For a given country, its legal system is the intersection of the ray emanating from the origin defining these proportions with its own IPF. The common law ray has a higher proportion of disorder to dictatorship than the civil law ray. Finally, as the IPFs shift out from developed to developing countries, the marginal amount of dictatorship required to reduce disorder rises: less developed countries (unlike the U.S. in 1900) cannot buy much order with regulation. As a consequence, less developed countries need *relatively* less dictatorship in equilibrium, i.e., less regulation.

Figure 5 describes the transplantation of common and civil law into a country with an IPF further from the origin. Whichever system is transplanted, the equilibrium amounts of dictatorship and disorder rise simply because the institutional possibilities are less attractive. Also, relative to efficiency, the transplantation of both civil and common law will lead to excessive intervention and regulation in lower civic capital countries. Finally, transplantation leads to higher levels of over-regulation in civil than in common law countries. Because of the enormous risks of public abuse of business, countries at lower levels of civic capital efficiently need less regulation. But when legal

**Figure 5: Transplantation of laws**



systems are transplanted, they end with as much relatively speaking, and more in absolute terms, than do the origin countries. This problem is most severe in civil law countries, which end up being especially over-regulated relative to efficiency.

Figure 5 is consistent with the findings of Djankov et al. (2002, 2003) and Botero et al. (2003) that levels of regulation are higher in poorer than in richer countries, and in civil law than in common law countries. Moreover, consistent with Figure 5, the evidence shows that, in poor countries, the levels of regulation are often excessive. Higher levels of regulation of entry are associated with larger unofficial economies and no measurable benefits for product quality (Djankov et al. 2002). Higher level of regulation of judicial procedure are associated with higher costs and longer delays, without offsetting benefits in terms of perceived justice (Djankov et al. 2003). Heavier regulation of labor is associated with larger unofficial economies, higher unemployment,

and lower labor force participation (Botero et al. 2003). In all these cases, the transplanted regulatory systems appear excessive for the countries that use them.

The evidence on the role of legal origin points to some tangible ways in which the existing institutions fall short of their potential, as well as to some possible directions for reform. The evidence suggests that deregulation – particularly in areas such as entry and labor markets, where the forces of competition are potentially so effective – is a high level priority for poor countries. In these countries, regulation is nearly universally associated with poor outcomes because public officials abuse their powers over private agents. Deregulation is likely to diminish the problems of dictatorship without a significant increase in disorder.

But the evidence also identifies some pitfalls of reform. One cannot assume, for example, that highly formalized general jurisdiction courts could efficiently resolve disputes in developing civil law countries. The most attractive areas for deregulation in developing economies are those where one can count on competition and market discipline, rather than on courts, to control disorder. In contrast, in the developed countries, courts – especially specialized courts – are becoming an increasingly attractive alternative to regulation.

So far, we have focused on the content of transplantation, and more specifically on the transplantation of the legal/regulatory regimes. But obviously, other institutions are transplanted as well. Moreover, how they are transplanted may also matter. Berkowitz, Pistor, and Richard (2003) and Pistor et al. (2002, 2003) stress the importance of “receptivity” for the success of transplantation of legal systems. Acemoglu, Johnson, and Robinson (2001) argue that the quality of institutional transplantation depends on whether the colonizers themselves settled in the occupied land, as they did in the U.S. or New Zealand, or just set up trading posts and exploited the colonies,

as they did in most African states.

All the evidence points to extraordinary importance of institutional transplantation. Legal origin as we discussed it proxies for the transplantation of institutions of social control of business: it captures the location of the transplanted institutions on the IPF, rather than the location of the IPF itself. As such, we expect legal origin to only affect growth indirectly, in so far as the specific mechanisms of social control affect markets for capital, labor, and entrepreneurs, thereby influence factor accumulation and productivity growth. Other aspects of colonization and transplantation may influence growth directly, by influencing the civic capital of the society, i.e., the location of the IPF.

Of these, human capital of the people operating the institutions is probably most important. Understanding the diverse consequence of transplantation is a crucial challenge for the new comparative economics.

## V. Politics.

Politics has a bad name in economics. From Marx (1872), to the Austrians (von Mises 1949, Hayek 1960), to institutional economists (Olson 1965, 1982, North 1990), to public choice scholars (Buchanan and Tullock 1962), to regulation economists (Stigler 1971), to political historians (Finer 1997), writers on institutions have maintained that political choice is often responsible for institutional inefficiency. Generals, dictators, ascendant social classes, democratic majorities, and favored interest groups all choose institutions that entrench them in power, so that they can collect political and economic rents. Constitutions, voting rules, federalist arrangements, organization of army and police are selected by incumbents to keep themselves in power. Olson (1993), Rajan and Zingales (2000), Acemoglu and Robinson (2000, 2002), Aghion, Alesina, and Trebbi (2002),

Glaeser and Shleifer (2002b), are some of the recent models examining these phenomena. In these models, there is no reason that the equilibrium institutional choice would end up on the IPF, let alone minimize total social losses, because Coasian negotiations between various players fail (Olson 2000, Acemoglu 2003).<sup>6</sup>

The political perspective predicts that equilibrium institutions can be either excessively disorderly or excessively dictatorial. Recent research on Yelstin's Russia argues, for example, that the oligarchs who came to strongly influence the government (like the robber barons in the pre-progressive-era U.S.) preferred institutional disorder as a strategy of maximizing their rents (Black and Tarassova 2003, Sonin 2003). More typically, as those in power attempt to stay in power, they help themselves and their supporters through excessive dictatorship. State ownership becomes a mechanism of dispensing patronage and maintaining political support for the incumbent politicians (Shleifer and Vishny 1994). Regulations with ostensibly benign goals end up protecting incumbent firms from competition, and offering extensive corruption and political support opportunities to their enforcers (Stigler 1971, De Soto 1989, Djankov et al. 2002, Bertrand and Kramarz 2002, Besley and Burgess 2002, Rajan and Zingales 2003). At the most basic level, the political perspective explains socialism itself – the system that concentrates all political power and economic decision making in the hands of a small elite, thereby providing this elite with the most powerful lever for perpetuating itself – making the whole population of a country dependent on it economically.

Despite the value of the political angle, it is premature to blame all institutional failure on politics. Politics is often a stronger force toward institutional efficiency than away from it. After

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<sup>6</sup>We do not discuss here a large literature on comparative political institutions. See, for example, Laffont (2000) and Persson and Tabellini (2000).

all, even communist dictatorships collapsed and turned into capitalist democracies. There are at least four significant ways in which the political process moves institutions toward efficiency. First, some institutions evolve over time toward more efficient forms as they confront new circumstances. This, fundamentally, is Hayek's (1960) view of the evolution of common law. Second, the reigns of government are often captured by interest groups favoring efficiency. De Long and Shleifer (1993), for example, show that, over the last millennium, the regions of Europe that were governed by merchants established good institutions and experienced rapid urban growth, whereas regions governed by absolutist princes did not do as well. Third, even when some interest groups oppose change, Coasian bargaining often does lead to efficient institutional choice (Becker 1983). The adoption of Magna Carta in England, and of the U.S. Constitution, are only the most famous examples of such bargaining. Last but not least, despite well-recognized problems with democratic voting (Buchanan and Tullock 1962), it is often a powerful force toward more efficient institutions (Wittman 1989). We have already discussed progressive reforms. On a broader scale, the enormous rise in the world's wealth during the 20<sup>th</sup> – democratic – century is the best evidence of the virtues of democratic politics.

The tendency of democratic states to seek efficiency is well illustrated by the adoption of that great American invention for balancing dictatorship and disorder – a rigid constitution with checks and balances (Brennan and Buchanan 1980). The clearest embodiment of such rigidity is the idea that courts themselves have the power to check laws passed by the legislature against the constitution. The American idea of constitutional review has spread to countries influenced by the U.S. Constitution, especially those in Latin America, but after World War II to many other parts of the world, including Continental Europe, as constitutional courts became common. La Porta, Lopez-

de-Silanes, Pop-Eleches, and Shleifer (2002) examine recent constitutions of 71 countries, identify the countries that have adopted judicial review in their constitutions, and find that constitutional review is indeed associated with greater political freedom.<sup>7</sup>

Not all efficiency-enhancing bargains have the sweet smell of the Magna Carta or the U.S. Constitution, but they may still improve welfare. During the 1990s, Russia's President Yeltsin fought the possible return of the communist dictatorship and extreme disorder arising from decentralized federalism and economic disorganization. Yeltsin's political, economic, and legal reforms generally required Coasian bargains with significant stakeholders, bargains that to uninformed observers appeared as failures of democratic rule. Privatization, for example, required deep concessions to enterprise insiders, the defeat of communists at the polls in 1996 called for a purchase of political support from the oligarchs, and the preservation of the federation demanded massive giveaways to independent regions (Boycko, Shleifer, and Vishny 1995, Shleifer and Treisman 2000). By the end of the decade, Russia emerged as a democratic, capitalist economy, with much stronger institutions than it had at the beginning of the decade, enabling Yeltsin's successor to continue his program and reap considerable benefits of stability and economic growth. In retrospect, many of Yeltsin's policies and institutional reforms look like welfare-improving strategies of combating dictatorship and disorder.

To take this point still further, consider the even more extreme example of Peru's President Fujimori and his director of Central Intelligence Agency, Vladimiro Montesinos. Montesinos was Fujimori's right hand man, managing the President's relations with other politicians, judges,

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<sup>7</sup> In transition economies and in West European constitutional deliberations, the creation of checks and balances has become a central issue of institutional design (Berglof et al. 2003).

business people, the media, foreign governments, and civil society. A principal tool of Montesinos' management was corruption: he routinely exchanged favors and bribes with key members of the elite. Unfortunately for Montesinos, he taped his conversations and exchanges. When Fujimori eventually escaped the country, the tapes became public. Ocampo (2003) reviews some of the tapes and documents the corrupt deals between Montesinos and over 100 members of the Peruvian elite. What do we make of this horrifying evidence?

On the one hand, this is a story of obscene dictatorship and corruption. But on the other, these deals were part of restoring order in Peru. Before Fujimori was elected, Peru was a country in the state of anarchy, with negative growth rate, continuous – and murderous – threat from the left-wing guerillas, the Shining Path, and incessant political battles among the elite. Fujimori restored order, destroyed the Shining Path, and attained significant economic growth during his rule. He did so, in part, by reducing conflict among the elites and entrenching himself in power through Montesinos' corrupt deals. From the perspective of Peruvian institutions, these deals reflect a move to eliminate disorder and increase dictatorship, which was probably efficient. The move is not attractive, but neither is the institutional possibility frontier that Peru faced. Eventually, as Fujimori attempted to consolidate his dictatorship, the political process worked and he was driven out of the country. Not surprisingly, disorder increased as well.

The often benign influence of politics is subject to an important caveat. Politics is fundamentally a negotiation between different interests, and the success of political negotiation itself relies crucially on the civic capital in the society – the ability to cooperate. Countries with higher civic capital, and the more attractive IPFs, are more likely to have successful political negotiations and to choose an efficient point on the IPF. In this very important way, the location of the IPF, and

the political choice of a point on it, are not independent. Even so, it is incorrect to blame all poor institutional outcomes on politics, since the failures of political negotiation are rooted in many of the same factors that undermine institutional opportunities in the first place.

## VI. Conclusion: Appropriate Institutions.

At least since the 18<sup>th</sup> century, economists have recognized that good institutions – those that secure property rights – are conducive to good economic performance. The appreciation of the benefits of good institutions has grown recently, in light of both the challenges of transition and development and the significant growth of empirical knowledge. But now economics can move further, and recognize that different institutions are appropriate in different circumstances. This, we believe, is the goal of the new comparative economics.

In this paper, we tried to put some flesh on this bare bones agenda. We argued that institutional diversity can in part be understood in terms of the fundamental tradeoff between controlling dictatorship and disorder. Many features of successful and unsuccessful institutions can be understood from this perspective. Moreover, this perspective sheds light on a range of historical experiences, including colonial transplantation, the rise of the regulatory state, and the transition from socialism. This perspective also maintains most forcefully that reforms in any country should be evaluated relative to its own institutional opportunities, rather than some idealized benchmark free of dictatorship and disorder.

The field of comparative economics has entered a fascinating new stage. The extraordinary turbulence in the world during the last decade – from post-communist transition, to Asian and Latin American financial crises, to economic and social devastation of Africa – has flagged the centrality

of institutional reforms, but also the many pitfalls along the way. We are all humbler and wiser now.

But we are also keenly aware that the comparative perspective, which identifies both the possibilities and the limitations of individual societies, can serve as a useful framework for future progress.

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