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 (private misconduct) and those of dictatorship (public misconduct). 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 with the comparisons of socialism and capitalism\(^2\). Under socialism, the principal mechanism of resource allocation is central planning. Under capitalism, this mechanism is the market. The field of 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.

The collapse of socialism in Eastern Europe and the Soviet Union a decade ago destroyed the traditional comparative economics as a field. The economic and political failures of socialism were too evident for any serious scholar to continue contemplating its comparative benefits. While the academic discussions have probably lasted longer than necessary, by 1990 it became abundantly clear that socialism produced little but 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 evolved into a new field. This field, which we call the new comparative economics, 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. Every capitalist economy has a large number of public and private institutions. These institutions function to choose political

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\(^2\)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.
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, and that these differences have significant consequences for performance. The
analysis of these institutions, with a focus on understanding which ones are appropriate in what
circumstances, is the subject of the new comparative economics.

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
therefore 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, squatting, theft, investor expropriation, and so on -- continue to
plague modern developing countries from Africa, to Latin America, to the Former Soviet Union.
On the other hand, a strong government – one 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 securing property rights is controlling 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 Austrian and 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, Easterly and Levine 1997, 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 about transition. Some of them dealt with controlling disorder. How much government ownership is desirable? Poland, the Czech Republic, and Russia pursued extensive privatization programs; China retained large state industries, yet grew the fastest. How interventionist should the government be? The transition
experience saw both successful regulation of markets, in Poland for example, and the
degeneration of regulation into corruption and selective abuse of new business in the countries of
the former Soviet Union (Frye and Shleifer 1997, Hellman, Jones, and Kaufmann, 2003,
McKinsey 1999). How much should the government be fighting disorder at all? Many writers
on transition saw public institutions as having limited use, and emphasized private orderings as
the means of securing property and contract (McMillan and Woodruff 1999, 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

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 for thinking about the tradeoff between dictatorship and disorder. We then apply this framework 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. Not surprisingly, these alternative 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, using several examples, that it provides useful predictions about institutional choices 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 benefit 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 in the form of murder, taxation, violation of property and agreements, 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.

Institutions function to control the twin dangers of dictatorship and disorder. We focus on a fundamental tradeoff of such control: a state that is powerful enough to control disorder is also powerful enough for dictatorial abuse. To a large degree, institutional design concerns itself with optimizing the consequences of this tradeoff.

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 a society. 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). On the y-axis are the social losses from a higher level
of disorder. 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 legal or a regulatory system – is a point on the IPF.

**Figure 1: Institutional possibilities**

In thinking about institutions, economist usually distinguish between written rules and their enforcement. A crucial feature of the framework presented in Figure 1 is that this separation disappears: a set of rules comes with its own enforcement properties, reflected in the equilibrium degree of dictatorship and disorder arising when this rule is used. Suppose, for example, that a country like Russia chooses to regulate its monopolies with an anti-trust agency. In this case, 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 shape and the location of the IPF obviously varies across activities within a society, as well as across societies. 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 or corporate takeovers, 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. It would be absurd to suggest that the institutional possibilities of modern England, or even China, are the same as those of Albania or Congo. Indeed, the movements of the IPF are as or more important for institutional quality and growth than the movements along the IPF. 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 have more attractive institutional possibilities, and an IPF closer to the origin.

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 proved 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.

Recent historical research has made progress in understanding the forces shaping civic capital. Landes (1998) continues the great tradition of stressing the role of culture in shaping institutions. Easterly and Levine (1997) and Alesina, Baqir and Easterly (1999) show how ethnic heterogeneity, and the resulting ethnic strife, constrain institutional possibilities. 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’s institutions. Acemoglu, Johnson, and Robinson (2001) argue in a similar spirit that the mortality of European settlers crucially shaped settlement patterns, and institutional outcomes. Recent research confirms the importance of the physical environment for institutional quality (Easterly and Levine 2003, Rodrik et al. 2002).

Other factors determining the location of the IPF are more prosaic, but possibly as important. As argued by Putnam (1993), societies with denser networks of non-governmental organizations that restrain public and private rent-seeking, such as the free press and community groups, have better institutions. Technology of production also matters. As societies develop, the scale of production and the pace of interaction among individuals rise, and 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 – crucially 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 on the margin. Presumably, when the government has a true monopoly on power, it takes little coercion to achieve a given level of order (both on average and on the margin); in a society close to anarchy, required coercion levels are much higher. Last but not least, the level of human capital in the society is itself likely to shape the location of the IPF, as better educated and informed people may be less likely to solve problems with violence.

Although we return to civic capital in our discussion of politics, in most of this paper we focus on choices along the IPF. The principal reason is the fact that the location of the IPF is significantly shaped by history, and as such may not be easily changed by reform. For most of the practical questions in economics, civic capital is a constraint rather than a choice.

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. Where this efficient point is located differs across societies and across activities within it. 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 society, such as the Magna Carta or the American Constitutional bargain (Becker 1983), or from a long term evolutionary process, as argued 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.

To think about the IPF and institutional choice in more concrete terms, consider the problem of social control of business, and the advantages and disadvantages of alternative institutions. Suppose that “the society” wishes to control business to reduce disorder from monopoly pricing, torts, predatory tactics, etc. There are four distinct strategies of such control, involving ever growing powers of the state 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 for social control of business are not mutually exclusive: competition and regulation often operate in the same market, as do private litigation and public regulation. Moreover, there are often intermediate strategies of social control of business, such as private litigation to enforce public rules, which lies somewhere between public regulation and private litigation. 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 damaged investors.

Finally, the society can nationalize security issuance, perhaps through the post office. 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 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.
Consider the four strategies of social control of business from the perspective of the tradeoff between dictatorship and disorder. The principal strength of market discipline as the method of enforcing good conduct is that it is free of public enforcers, and of all the baggage that comes with them. 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. On the other hand, market discipline may be very weak at controlling disorder. Market participants can use their economic, political, or social resources to damage their customers and rivals using 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.

In many instances, this case for the effectiveness of private orderings and market discipline is 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.

As another example of how market forces could work well without any government
interference, consider the regulation of entry: the control of entry by new entrepreneurs through licensing and permits (De Soto 1989, Djankov et al. 2002). Since entering firms are small, and since any failure to deliver quality products and services would be almost immediately be discovered and penalized by their customers, it is not clear why the quality of entrepreneurs or of their firms should be regulated at the entry level. A baker selling bad bread would lose customers almost immediately, as would a bad watch repairman or car mechanic. To the extent that market discipline can control disorder, regulation, or even courts, are unnecessary.

But this is far from always being the case. Monopolies, especially natural monopolies, are the obvious example where market pressures are weak, and hence cannot be counted on to control disorder. Employers may under-invest in safety and then blame accidents on an injured worker’s own carelessness (Fishback and Kantor 2000). In security issuance, a fraudulent scheme can separate investors from their money very quickly, and undermine confidence in markets. The sellers of bad securities, meanwhile, are too rich to worry about raising funds in the future. 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 and less disorder by relying the enforcement of good conduct through private litigation. Injured employees can sue their employers for damages. Investors can sue issuers and underwriters for damages when they believe that representations about the company’s prospects were false or incomplete. Ideally, a judge would recognize quickly whether investors have been misled, and award damages to compensate investors for their losses. Such judicial enforcement of contracts and torts are seen by libertarians as sufficient guarantees of security of
property.

Private litigation has many advantages. At least 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, even in civil law countries where they explicitly work for the executive, and even more so in common law countries where they are notionally independent, can enforce private contracts without reference to the demands of “public policy.” Judges may also develop expertise in contract enforcement (as well as in handling tort cases), and hence address problems efficiently and expeditiously. This, indeed, is what Coase (1960), Nozick (1974), and Posner (1985) have in mind.

The reality of litigation is, unfortunately, not so perfect, and the tradeoff between dictatorship and disorder is helpful for thinking about courts as well. To begin, the same forces that undermine the effectiveness of private orderings influence courts as well. As a consequence, courts are often subverted so the powerful and not the just win the case (Glaeser and Shleifer 2003, Glaeser, Scheinkman, and Shleifer 2003). Some of the mechanisms of influencing courts, such as hiring superior lawyers and using delay tactics, are entirely legal. Other mechanisms, such as political influence on judges, are more prevalent in countries where the judiciary is not politically insulated (Ramseyer and Rasmussen 1997). In still other countries, judges are bribed with cash, benefits, or promises of promotion, but also 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 use their resources to influence the path of justice, pure litigation cannot be counted on as an effective mechanism of enforcing socially desirable conduct.

One 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. Most countries in the world, especially those in the civil law tradition, heavily formalize their laws and procedures to assure accuracy, and to prevent subversion of justice. These 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 the subversion of judges is to make them employees of the state, whose career concerns protect them from succumbing to outside influence. Put differently, independent judges are more vulnerable to private subversion than the state employed ones – a concern that Glaeser and Shleifer (2002) argue is central to the divergence between common law and civil law as far back as the 12th and 13th centuries. The trouble is that, as judges become more dependent on the state, the risk of politicization of their decisions rises. The less independent are the judges, the more likely they are to pursue political objectives in controversial decisions, and the greater are the social losses from dictatorship.

Like market discipline, litigation is effective in many circumstances. It works better where judges are insulated from political pressure, which is probably the case in the more advanced economies. It is also likely to be more effective in the cases where the problem of “inequality of weapons” between the litigants is smaller (Hellman and Kaufmann 2003). In relatively wealthy and equal economies, for example, tenant landlord disputes or employment contract disputes may well be most efficiently resolved in specialized courts. Yet in countries and in the types of conflicts where judges are vulnerable to subversion, and the inequality of weapons is considerable – as for example in large commercial disputes or in disputes involving officials – pure private litigation is unlikely to be the efficient method of enforcing socially desirable conduct. Mechanisms for social control of business that are more effective at
controlling private disorder, but more vulnerable to “dictatorship,” may be needed.

This brings us to the third strategy of enforcing good conduct, namely government regulation. Regulation has been an anathema to libertarians such as Nozick (1974), who see a sharp distinction between the enforcement of rules by judges and that by the 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 most clear, note that a step short of full-fledged public enforcement, there is an extremely important intermediate strategy, namely private enforcement of public rules. In principle, the government can create a set of 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 broad contractual principles. It may be efficient, for example, for the government to specify appropriate safety standards but to leave the enforcement of these standards to workers or consumers through private suits. Likewise, the government can mandate specific disclosures by a company issuing shares, but then leave the enforcement 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 issuer negligence in the absence of a statute.

Private enforcement of public statutes addresses a number of problems of disorder inherent in pure litigation. First, as the examples above suggest, the burdens on the courts and the plaintiffs of establishing 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 and expensive 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 (Hay and Shleifer 1996, Hay, Shleifer and Vishny 1998). As La Porta, Lopez-de-Silanes, and Shleifer (2002b) show, this is a crucially important strategy for enforcing good conduct in security issuance in many countries.

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 meatpacking plants during the progressive era in the U.S. at the beginning of the 20th century are sometimes interpreted as an attempt by large established firms to restrict entry by smaller rivals by raising these rivals’ costs from 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 in the U.S. and elsewhere (Landis 1938, Johnson et al. 2000). A regulator can establish expertise, for example, in what constitutes material omission from a prospectus, present market participants with specific rules, and then use its resources to make sure that these specific rules are followed by imposing its own sanctions or by convincing courts to adopt its rules. Second, going back to the previous point
about statutes, to the extent that the regulators are empowered to create specific rules, they may face relatively lower costs of enforcement than do the generalist judges (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). This combination of expertise and incentives makes public enforcement more efficient than private enforcement in some circumstances.

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 is 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.

So what are the circumstances in which regulation is an appropriate strategy of restraining harmful conduct? 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. This implies that the case for regulation is most compelling in situations where the problem of inequality of weapons between private parties involved in a transaction is too severe. Natural monopolies present a strong case for regulation. Securities issuance is another instance; perhaps workplace safety is yet another. In contrast, entry of new firms is unlikely to require regulatory control. Likewise, most labor regulations in environments that have competition for labor are difficult to justify on efficiency grounds.

Finally, one can imagine situations where nothing short of government ownership can
eliminate disorder. If monopolies cannot be restrained through regulation, if quality is essential but cannot be assured except with full state control, if public safety is jeopardized – these are the instances where one can make a plausible case for state ownership. Interestingly, both during the progressive era in the U.S., and during the post-World-War-II period in Western Europe, advocates of state ownership emphasized not just the economic, but also the political power of large business in their case for nationalization (Shleifer 1998, Glaeser 2003, and Glaeser and Shleifer 2003). 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 public abuse. Because the government uses its control to pursue political ends (Shleifer and Vishny 1994), the performance record of state enterprises around the world has been dismal, and the benefits of privatization large (e.g., 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 illustrates 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 1990). Although the efficiency case for state ownership as a means of controlling
disorder can be made, the range of activities where this case is compelling is modest.

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 for 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 rise of the regulatory state in the progressive era U.S., the divergence between France and England in the 12th and 13th centuries in their choices of legal systems, and post-communist transition. In all three applications, we maintain the assumption that institutional choice is efficient given the institutional possibilities of a country.

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 19th 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 2). 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.

As Figure 2 shows, the efficient institutional choice in the American economy in response to this shift in the IPF called for higher levels of dictatorship to provide the countervailing power to big business. 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. It is crucial to note in this regard, that, in

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equilibrium, the level of disorder may well have increased relative to the mid-19th century – this by itself does not imply that the progressive reforms were ineffective. It is equally crucial to note, with Stigler (1971) and his followers, that the level of dictatorship has increased as well. Indeed, the greater power of the state has led to greater benefits of state capture, and therefore 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.

Figure 2: Progressive reforms

Legal Origins

In the 12\textsuperscript{th} and 13\textsuperscript{th} centuries, England and France established the foundations of their modern legal systems. These systems took rather different forms. England established 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 the reliance on procedural and substantive codes rather than judicial discretion. Over the years, 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) present an analysis intimately related to Figure 1 to understand this divergence (indeed their model can be used as a micro-foundation for Figure 1). The authors argue that a crucial feature of any legal system is its vulnerability to subversion by the powerful (disorder). The greater the pressures on courts to rule for the strong rather than the just, the greater are the levels of centralization (dictatorship) needed to counter the 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 12th and 13th 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 control disorder, it was efficient for France to adopt a legal system with a higher level of dictatorship than England, even though the cost of such adoption was relatively greater scope for sovereign abuse of the law.

Figure 3 illustrates the relevant choices, where we think of the French IPF as a shift out of the English IPF, but also as a tilt. The equilibrium 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. So here as well, modeling efficient institutional choice allows for a range of predictions.

**Figure 3: Legal origins**

**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, though not all, 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 Boris 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 (Murphy, Shleifer and Vishny 1992, Blanchard and Kremer 1997), but even as markets began to work and the economy settled down, 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, Russia – like the U.S. in the decade 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 experience with the collapse of communism can be plausibly described as a sharp move up along its IPF.

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 remain utterly lacking in personal, economic, and political freedom, but they also did not experience the rise in disorder. Tellingly, Belarus and Uzbekistan retained extremely small unofficial economies, the 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. Finally, their central control avoided the problems of localism. Not surprisingly, these countries have failed to experience the benefits of economic transition from communism, and over the decade performed much more poorly than Russia.
The lack of the institutional transformation that our model captures is the main reason.

Compared to Russia, Eastern Europe had a more attractive IPF. East European countries had a much shorter experience with 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, including the free press and, in the case of Poland, a very independent Church. They were also more integrated into Western Europe, and from the beginning anxious to join the European community, which substantially restricted the tendencies toward both dictatorship and disorder.

But even recognizing the more attractive IPF for East European countries than for Russia, the crucial question remains as to why Eastern Europe, following the collapse of communism, did not move as far in the direction of disorder as Russia under Yeltsin. The various checks and balances in the political systems of Poland, the Czech Republic, and Hungary, emphasized by Hellman (1998) and discussed in Section V, are one possible reason. These checks and balances include both divided government, and the factors mentioned in the previous paragraph that limit institutional subversion and disorder. The absence of federal structures, which have been central to the rise of disorder in Russia, may also be important.

A strong case can be made that Russia in the 1990s stayed on its institutional possibility frontier. It has moved away from a devastatingly inefficient point of communist dictatorship, but 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. It remains to be seen whether, as a consequence, it can attain East European levels of institutional development.
IV. Transplantation.

We maintained in the previous section that one can explain a great deal of institutional diversity by focusing on efficient institutional choice. But this is clearly not the whole story. One dramatic deviation from the assumption of indigenous formation of institutions is the experience of transplantation. As European powers conquered much of the world in the 19th century, they brought with them their institutions, including their laws. A significant portion of institutional variation among countries, particularly with respect to the legal systems, is accounted for by transplantation (Watson 1974, La Porta et al 1997, 1998).

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 of 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 20th 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. Finally, 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), as well as 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, Wurgler 2000, Beck et al. 2003, Friedman et al. 2003, LA Porta et al. 2000, 2002).

Subsequent research also shows that common law works better than French civil law in protecting investors for precisely the theoretical reasons we have outlined. Johnson et al. (2000) argue that judicial discretion, as opposed to literal interpretation of the codes, helps shareholders recover damages when managers are involved in self-dealing transactions. More recently, La
Porta, Lopez-de-Silanes, and Shleifer (2002b) study securities laws around the world, and argue that private litigation to recover damages from a purchase of worthless securities, associated with the common law tradition, is closely associated with the development of securities markets.

Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002, 2003) and Botero et al. (2003) take these comparisons further by considering various domains of government regulation across countries, 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 lessons emerge from the analysis. Countries appear to have pronounced styles of social control of business intimately related to the legal origin of their laws. In all three areas of regulation -- entry, courts, and labor -- socialist and French legal origin countries regulate activity 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). The evidence on regulation thus closely parallels the evidence on finance.

Moreover, 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 colonial 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 colonial transplantation. We think of a legal system as a combination of 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 the country’s own IPF. As we argued earlier, the common law ray has a higher proportion of disorder to dictatorship than the civil law ray (perhaps because England needed less dictatorship in its legal system). Finally, as the IPFs shift out from developed to developing countries, the marginal amount of dictatorship required to reduce disorder by a given amount rises, so that, in equilibrium, the optimal ratio of dictatorship to disorder falls. Put differently, 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 than the origin country. It shows that, whichever system is transplanted, the equilibrium ratio of dictatorship and disorder will rise, simply because the institutional possibilities are less attractive. It also shows that, relative to efficiency, the transplantation of both civil and common law will lead to too much intervention and regulation in lower civic capital countries. Finally, it shows that relatively speaking, transplantation will lead 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 require less regulation. But when legal systems are transplanted, they end up with as much relatively speaking, and more in absolute terms, than do the origin countries. This problem is particularly severe in civil law countries, which end up especially over-regulated relative to efficiency.

Figure 5: Transplantation of laws

Figure 5 is consistent with the Djankov et al. (2002, 2003) and Botero et al. (2003) findings that levels of regulation are higher in poorer than in richer countries, and in civil law than in common law countries. Moreover, consistent with the analysis in Figure 5, the evidence shows that, in poor countries, the levels of regulation are often excessive. For example, higher levels of regulation of entry are associated with larger unofficial economies and no measurable benefits for the quality of products (Djankov et al. 2002). Likewise, there is no evidence that, in
developing countries, higher level of regulation of judicial procedure yields any benefits: in fact, more formalized legal systems appear to cost more and to produce higher delay, without offsetting benefits in terms of perceived justice (Djankov et al. 2003). Again, the transplanted regulations appear to be inappropriate for the circumstances of 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. In particular, 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 points to some of the pitfalls of reform. For example, one cannot assume that highly formalized general jurisdiction courts in developing civil law countries could efficiently resolve disputes. 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, and moreover, how they are transplanted may also matter. With respect to the transplantation of legal/regulatory systems, Berkowitz, Pistor, and Richard (2003) and Pistor et al. (2003) stress the importance of indigenous change, and argue that voluntary adoption leads
to better functioning institutions than forced transplantation. Acemoglu, Johnson, and Robinson (2001) point out further that the quality of institutional transplantation depends significantly 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 transplantation for the colonies. Legal origin as we discussed it proxies primarily 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, therefore 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 Austrians (von Mises 1949, Hayek 1969), 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 (1982), 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 at the point that minimizes total social losses because Coasian negotiations between various players fail (Olson 2000, Acemoglu 2003).

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). Perhaps more typically, as those in power attempt to stay in power, they use the levers of government to help themselves and their supporters through excessive dictatorship and control. State ownership becomes a mechanism of dispensing patronage and maintaining political support for the incumbent politicians (Shleifer and Vishny 1994). Various regulations, which have 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). 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 of perpetuating
itself -- making the whole population of a country dependent on it economically.

But despite the successes of the political perspective, we believe it is premature to blame institutional failure on politics. Politics is often a stronger force toward institutional efficiency than away from it. After all, even communist dictatorships have collapsed and turned into capitalist democracies. More generally, there are at least four significant reasons to believe that politics 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, not all interest groups are necessarily regressive, and the reigns of government are often captured by interest groups favoring efficient institutions. De Long and Shleifer (1993), for example, show that, over the last millenium, the regions of Europe that were governed by merchants established good institutions and as a consequence experienced rapid urban growth, whereas regions of Europe governed by absolutist princes did not do as well economically. Third, even when some interest groups oppose change, Coasian bargaining often does lead to efficient institutional choice (Becker 1993). 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), democratic voting support is often a powerful force toward more efficient institutions (Wittman 1989). We already discussed progressive reforms, but, on a much broader scale, the tremendous increase in the world’s wealth during the 20th – democratic – century is the best evidence for the virtues of democratic politics.

The tendency of democratic states to seek efficiency is well illustrated by the wide adoption in the 20th century 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 the decisions and 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, and in particular identify the countries that have adopted the American invention in their constitutions. The authors find that constitutional review is associated with greater political freedom, consistent with the notion that constitutions can offer guarantees against excessive political interference in everyday life. In modern transition economies, as well in West European constitutional deliberations, the creation of checks and balances has become the central issue of design (Berglof et al. 2003).

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 extreme disorder arising from communist opposition, decentralized federalism, and economic disorganization with a series of institution-building reforms. These 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 in had at the beginning of the decade, enabling Yelstin’s successor to continue his program and reap considerably benefits of stability and economic growth. In retrospect, many of Yelstin’s policies and institutional reforms look like welfare-improving strategies of combating extreme 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, 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 so, when President Fujimori eventually escaped the country, the tapes became public. In a recent study, Ocampo (2003) reviews some of the tapes, and documents corrupt -- and taped -- 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 pervasive corruption. On the other, one might take a somewhat broader view of Fujimori’s rule. Before he 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 Montensinos’ 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.

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 IPF, 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 probably incorrect to blame poor institutional outcomes on politics, since the failures of political negotiation are rooted in many of the same factors that undermine institutional opportunities.

VI. Conclusion: Appropriate Institutions.

At least since the 18th century, economists have recognized that good institutions -- those that secure property rights -- are conducive to good economic performance. The appreciation of the importance of good institutions has grown recently, both in light of the real economic problems of transition and development, and in light of significant growth of empirical knowledge. At this juncture, however, economics can move further. It can move beyond a broad appreciation of good institutions, and recognize that different institutions are appropriate in different circumstances. The variety of successful, as well as unsuccessful, capitalist models shows that we need to understand how institutions form and develop, and what makes some of them work. This, we believe, is the goal of new comparative economics.

In this paper, we try to put some flesh on this bare bone agenda. We argue that
institutional diversity can in part be understood in terms of the fundamental tradeoff between controlling private misconduct (disorder) and public misconduct (dictatorship). 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. The 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 the possibilities but also the limitations of individual societies, can serve as a useful framework for future progress.
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