

**IMF Working Paper**

© 1997 International Monetary Fund

This is a *Working Paper* and the author(s) would welcome any comments on the present text. Citations should refer to a *Working Paper of the International Monetary Fund*. The views expressed are those of the author(s) and do not necessarily represent those of the Fund.

WP/97/11

INTERNATIONAL MONETARY FUND

African Department and European II Department

**Towards a Market Economy: Structures of Governance**

Prepared by Pierre Dhonte and Ishan Kapur <sup>1</sup>

December 1996

**Abstract**

This paper proposes an operational interpretation of the concept of economic governance. It argues that the capacity of governments to credibly ensure a secure economic environment provides an important benchmark against which governance can be evaluated. Such an environment—which is essential for sustained growth in a market economy—can be established through a rules-based system which ensures freedom of entry into the market, access to information, and sanctity of contracts. Since creating a secure economic environment involves profound, far-reaching social change, it has historically been a complex and lengthy process in most societies. However, basing policy prescriptions on this benchmark helps avoid possible conflicts between different social and moral values.

**JEL Classification Numbers:** D78, E61, H11

**Author's E-Mail Address:** [ikapur@imf.org](mailto:ikapur@imf.org)

---

<sup>1</sup> The authors gratefully acknowledge comments from Jack Boorman, Manuel Guitián, Michael Hadjimichael, Ernesto Hernández-Catá, Jorge Márquez-Ruarte, Abbas Mirakhor, John Odling-Smee, and Emmanuel van der Mensbrugge. The views expressed in this paper do not necessarily represent those of the International Monetary Fund.

## Summary

Sustainable long-run growth requires the creation of a secure economic environment to encourage investment. Such security results from the assurance that the return on enterprise and investment will accrue to the entrepreneur and investor. In this regard, the credibility of government policies, notably the resolution of time-consistency problems, is critical to reducing uncertainty and thus establishing a secure environment.

While the need for a secure environment is universal, the extent to which it is satisfied—as well as the process by which it comes about—varies between alternative sociopolitical systems. A distinction is made between patrimonial and rule-of-law systems; the former are characterized by uncertainty resulting from the ruler's unfettered discretion, while the latter are based on rules that seek to establish predictability by limiting this discretion. Creating a secure economic environment through the transformation of societies from patrimonial to rules-based regimes is a complex and protracted process involving profound, far-reaching social change.

Market-based economic systems pre-ordain the rule of law by encouraging free entry to markets, access to information, and sanctity of contracts. This limits rent-seeking activities and creates a secure environment. The capacity to provide credible economic security constitutes an important, though by no means exclusive, benchmark against which economic governance can be evaluated. The core of good governance is a rule-of-law system in which the three conditions, cited above, effectively hold. This benchmark has the advantage of avoiding potential conflicts which could arise with broader criteria based on different moral or social values. Thus, policy prescriptions can be reduced to relatively straightforward choices involving the efficiency of markets with the aim of establishing a framework (standards, rules, and institutions) of a secure economic environment.

## I. INTRODUCTION

A secure economic environment is critical to sustained growth in a market economy. This paper argues that such an environment requires the existence of effective laws and institutions, including the government, which must ensure that there is freedom of entry into the market, access to relevant information, and the security of contracts.<sup>2</sup> Thus, “good” governance promotes the creation and maintenance of these conditions in a rules-based system. Historical experience suggests that establishing a secure environment, notably in developing and transition economies, involves complex, far-reaching and protracted social change. Consequently, economic policy prescriptions regarding governance should be highly selective and devoid of moral judgements.

## II. THE NEED FOR A SECURE ECONOMIC ENVIRONMENT

A secure economic environment results from the assurance that the return on enterprise and investment will accrue to the entrepreneur and the investor; as such, it is a critical requirement for sustained growth. The provision of such an environment is particularly important for the development of private initiatives in a market economy, in contrast to government investment (or investment by an enterprise in a command economy) which is less dependent on the certainty of expected returns and where the government is in a better position to influence the outcome.

Among the various dimensions of a secure environment are: efficient law and order (including protection from external threats—which could be economic or social, and not just military—and from domestic racketeering), reasonable macroeconomic and political stability and, critically, the credibility of the government as perceived by the investor. The risk for the investor is that the business environment, as shaped by government behavior and policies at a point in time, may be adversely affected by shifts in government policy, resulting in harm to the conduct of business, a lowering of the rate of return, or—in the extreme—the seizure of assets.

An insecure environment has two effects on private investment decisions: first, it lowers the expected return on enterprise and investment; second, it increases the dispersion of possible outcomes. Recent analytical discussion has suggested that these two effects are not subsumed in each other, but are additive, i.e., the increased dispersion of outcomes has an adverse effect over and beyond the lowering of the average.

The importance of this consideration for investment behavior has been highlighted in recent years by renewed emphasis on the irreversibility of investment decisions. As a result, an insecure environment provides a potential investor with an incentive to wait: the threshold

---

<sup>2</sup> These considerations also apply to markets in property rights of various types, e.g., physical, intellectual, and financial assets.

rate of return of the investment decision is increased by a margin which represents the “option value” of waiting, i.e., the value of keeping one’s options open; moreover, uncertainty shortens the business planning horizon, thus adversely affecting capital accumulation. By reducing the uncertainty, economic security lowers the threshold and increases the rate of investment (Serven, 1996).

While government credibility has long been recognized by casual observers and in business circles as a major consideration in shaping investment decisions, its formal integration into economic policy analysis is a relatively recent development. The basis for this integration is provided by game theory and can be illustrated as follows in an arrangement with two players: if player A (an investor) feels that he is at risk of predatory behavior by player B (a government), he may choose not to invest; the result is that both will be less well off than they would be if they could agree on credible, appropriately low, limits on predation by B. An interesting point is that this situation does not depend on whether B is actually “benevolent” or not, but on whether it can be trusted as such by A. Thus, it is not enough for a government to propose “good” policies; it is even more of the essence that the process of proposing and implementing these policies be such as to give them credibility. In sum, the manner in which various players establish credible assurances to all concerned that they will all behave consistently over time is of fundamental importance for generating investment.

The importance of predictability as a basis for generating credibility was put in focus in the early 1980s in discussions of the efficiency of anti-inflation policies. It was recognized that governments could face a difficult task in establishing their credibility in those cases where they faced “time consistency” problems, i.e., where the optimal policies after credibility has been established might not be the same as before it is (for example, a government that has managed to impose an incomes policy in the interest of fighting inflation may then have an interest in devaluing to cut real wages and reduce unemployment). In such circumstances, the government has little choice but to give up part of its discretionary policy-making powers and subject itself to a binding rule be it by subjecting itself to specific institutional arrangements or by capitalizing on a tradition, a “track record” of virtuous behavior.<sup>3</sup> In short, since “predictability” is a key factor in credibility and an economically secure environment, it perforce becomes a central issue of economic policy making and implementation.<sup>4</sup>

---

<sup>3</sup> In analyzing hyperinflation in several countries, Lucas (1986) found that the common feature was that anti-inflationary policies did not succeed until the governments concerned adopted measures that resolved time-consistency problems.

<sup>4</sup> The absence of economic security is probably the single most important impediment to growth in most transition economies, and certainly—several years after reforms began—it remains the primary obstacle in most states of the former Soviet Union. For an excellent discussion of this issue see Chapters 4 and 6 in European Bank for Reconstruction and Development, *Transition Report 1995*.

There is abundant, albeit recent, empirical evidence that economic security, or the lack of it, has a significant influence on private investment and on growth. Most empirical work augments recognized specifications of GDP, investment or saving equations by including proxies for economic security, and tests for the significance of these proxies, but with varying results. Hadjimichael and Ghura (1995) have studied the behavior of investment in selected countries using measures of macroeconomic uncertainty and measures of political stability (indices of political and civil liberties). They find the expected direction of impact, but with limited significance.

A survey of these studies in Borner et al. (1995) explains why the empirical results appear to be mixed. What matters, in their argument, is the “gut feelings of entrepreneurs with regard to their confidence in government predictability”, feelings which are not adequately captured by measures of political stability. To confirm this thesis, they construct an indicator of political credibility, based on survey responses to two questions relating to the frequency of unexpected changes in laws and/or policies, and to whether the government is expected to adhere to major announced policies. They find that the political credibility indicator constructed from these questions is a significant and robust determinant of the real GDP growth rate and that the effect works mostly through its influence on private investment. These results are similar to those of Knack and Keefer (1995), who use indicators of contract enforceability and risk of expropriation in various countries in estimates of growth equations, and find that the rates of convergence to the level of incomes in the United States increase noticeably and robustly when these variables are included in the regressions. In the same vein, using a wide array of indicators of political and economic security, including specific indicators for the enforcement of contracts and the quality of the bureaucracy, Fabricius (1996) finds a significant influence of security on investment. His results confirm those of Mauro (1996), who constructs a corruption index as an average of two commercially available country ratings and finds a considerable magnitude of the effect of this index on per capita income growth as well as a significant relationship with the investment ratio.

Following a different approach, Olson (1996) arrives at results consistent with the above evidence. Variations in growth performance among country groups are analyzed by linking them to differences in endowments: as the latter in his view do not even begin to explain the discrepancies in performance, he concludes that the “only remaining plausible explanation is that the great differences in the wealth of nations are due mainly to differences in the quality of their institutions and economic policies”; earlier work by Lucas (1990) and Barro and Sala-i-Martin (1995) suggests, however, that these results may not be fully robust.

### III. SECURITY UNDER ALTERNATIVE SOCIO-POLITICAL STRUCTURES

While the need for a secure economic environment is universal, the extent to which it is satisfied—as well as the process by which it comes about—varies between alternative systems. In this regard, an essential distinction has to be made between patriarchal and “rule of law” socio-political systems, with the critical feature being the scope of the ruler’s discretion.<sup>5</sup> The patriarchal system relies on the authority of the patriarch to enforce law and order and on his far-sightedness or enlightenment to ensure predictability; the ruler’s discretion is unrestricted in principle and the system rests on personal trust.

At the other end of the spectrum, the “rule of law” system is based on largely stripping the ruler of discretionary powers. Its essence is best expressed in Hayek’s crisp and non-technical formulation of the rule of law: “...this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one’s individual affairs on the basis of this knowledge” (Hayek, 1944).

This pivotal difference between “rules” and “discretion” leads to a parallel distinction between patrimonial and centrally-planned systems on the one hand, and market systems on the other. A key attribute of patrimonial or centrally-planned systems is the ruler’s (or government’s) ability to farm out pieces of the economic fabric: in effect its right to grant monopolies in property ownership, production, trade, etc. Since the ruler’s fiat is the organizing principle of activity, the system cannot achieve complete investor confidence, no matter how “benevolent” it is or appears to be. Predictability in this system is always subject to the limitations imposed by the ruler’s retained right to prey on economic output or arbitrarily alter the allocation of resources. For this reason, such a system can be effective as a means of implementing centralized initiatives, but much less so when it comes to creating a suitable framework for mobilizing decentralized initiatives.<sup>6</sup> In contrast, a market system pre-ordains the rule of law by ensuring three basic conditions: free entry to markets, access to information, and the objective sanctity of contracts.<sup>7</sup> This limits rent-seeking activities

---

<sup>5</sup> This distinction is inspired by Weber’s contrast between patriarchal and bureaucratic domination (Weber, 1978). As in Weber’s work, the distinction is starkly drawn for the purposes of exposition; in the real world, most societies contain some characteristics of the two systems and their actual functioning is likely to soften the distinction even further.

<sup>6</sup> The legal and institutional functioning of a centrally-planned economic system have been recently described in a study of the Soviet economy by IMF et al. (February 1991).

<sup>7</sup> Clearly, in the real world the concept of free entry into markets must take into account the important regulatory role that public institutions should, and do, play e.g, stock market supervisory agencies or oversight agencies in the financial sector. Furthermore, the sanctity of

(continued...)

and precludes the grant of a monopoly as a basis for security; thus, the predictability of government decisions rests on the limits imposed on its discretionary powers by the establishment and enforcement of the rule of law. This requires a broad social and political consensus which, in turn, implies that markets develop progressively over a period of time; in that process, the force of law gradually becomes attached to the initial conventions needed for their functioning (Rawls, 1971) .

The transition from a patrimonial (or centrally-planned) system to a market-based one is thus not just a simple move from “more” government to “less” government, but more from one type of government to another. Over the past few years, Stiglitz (1994) has raised thoughtful issues regarding role of government in imperfect markets (which, he correctly notes, is more relevant than the “quite irrelevant paradigm of perfect competition”) and argued that the key issue “is not markets versus government, but the appropriate balance between the two.” There is a common misconception which inversely links the extent of the state’s involvement in the economic system to the quality of economic policies and performance, without acknowledging that this quality is determined largely by a positive socio-political framework which only the state can provide. Among others, Olson (1993) has convincingly argued that “the familiar assumption that the quality of a nation’s economic institutions and policies is given by the smallness, or the largeness, of its public sector...does not fit the facts very well.” Rather, he notes a strong linkage between better economic policies and the existence of institutions that make property rights secure over the long run, enforce contracts impartially, and prevent “private and public predation.”

The process of transition from patriarchal to rules-based systems is driven by two sets of forces:

- The need to overcome the time-consistency problem that forces rulers to give up their discretionary powers becomes more pressing as financial deepening progresses. The development of appropriate institutions facilitates a process in which all participants overcome this problem. As noted by Bates (1996), one remarkable feature of the time-consistency problem is that the ruler has a vested interest in establishing credible limitations on his predatory powers, i.e., subjecting himself to a rule of law. It is worth noting, in this respect, the view that by imposing such restrictions the government can increase its creditworthiness; or, to take a modern example, the independence of the central bank represents a means to deprive the government of its power to fuel inflation and therefore strengthens the credibility of anti-inflation policies (Agenor, 1993). It is no small paradox that a market system depends critically on the quality of its institutions.

---

<sup>7</sup>(...continued)

contracts does not preclude changes in public policies (for example, in tax laws) as long as these are carried out within the framework of a rules-based system.

- The ideological push for individualism and social egalitarianism, with the attendant emphasis on “virtue” instead of “honor” as a cardinal social value (Oakeshott, 1993), gains ground from demonstration effects as information and communication becomes widespread. As it does, the emphasis on prestige gives way to a search for efficiency: white elephants, that previously celebrated the ruler’s dominion, lose their value as a basis for the social compact to more down-to-earth concerns such as basic infrastructure, feeder roads, and stable prices.

This brief discussion shows that the distinction between alternative regimes as a basis for a secure economic environment is profound and far-reaching: it has implications for society’s political structures, for its fundamental social values, for the regulation of economic activity. It is thus not surprising that, where they now exist, market-based economic security systems have been the outcome of a long, drawn-out process of increased recognition of the rights of the individual to the point where these have taken precedence over the sovereign as the foundation of social cohesion.<sup>8</sup> Similarly, today, in developing and transition economies, a successful effort to develop market institutions entails, and coincides with, an effort to develop individual liberties. The transparency and accountability that are substantive of market systems are incompatible with the survival of patrimonial regimes; moreover, the disintegration of patrimonial systems is invariably accompanied by a transition from monopolies to competition.<sup>9</sup> For these reasons, efforts to develop market systems are often considered to be antagonistic behavior by the regimes in place and elicit active resistance.<sup>10</sup>

#### IV. GOVERNANCE AND THE FUNCTIONING OF ECONOMIC SYSTEMS

In general, the concept of “governance” has been rather loosely defined. In this paper, it is simply taken to mean the act of governing, i.e., the relationship between the government and the people, which can express itself in a variety of political or social systems. In a broad approach, the Development Assistance Committee of the OECD has defined governance from the particular viewpoint of donors as denoting the “use of political authority and exercise of control in a society in relation to the management of its resources for social and economic

---

<sup>8</sup> As an illustration, France’s economic transition spanned several centuries of political change: from Colbert’s introduction of a system of government accounts in 1660—a first step towards transparency—through the French Revolution, and to the adoption of a generalized personal income tax in 1905. In some respects, the process is still incomplete.

<sup>9</sup> Under this argument, the co-existence of patriarchal political regimes and market-oriented economic systems is a transitional phase, since development of advanced market mechanisms is over time incompatible with the former, i.e., sustainable long-run growth is not consistent with patrimonial regimes.

<sup>10</sup> The linkage between political (and institutional) reforms and economic performance in Russia and Poland has been interestingly described by Shleifer (1996).



development”; moreover, three specific aspects of governance are identified: the form of political regime, the processes by which authority is exercised in the management of a country’s economic and social resources, and the capacity of government to formulate and implement policies and discharge its functions (OECD, 1993). Even more broadly, World Bank documents have used the concept of governance to “capture and define the interest of both the World Bank and other international institutions in the political and institutional factors affecting structural adjustment” (Frischtak and Atiyas, 1996).

In itself, governance is a morally neutral concept; it is also not limited to economic activities. Its basis is the decision-making authority ceded to the governors by individuals (voluntarily or not) so that the common interests of collective society can be served.<sup>11</sup> There may be different forms of governance resulting from the specific socio-political framework within which a people rules itself, in particular the moral order which underlines the society in question. Political stability by itself does not, of course, automatically ensure good governance. A judgement whether economic governance is good or bad in most contemporary Western societies is usually based on their capacity to support efficient markets within a framework largely derived from common values. However, even among these western market economies, the relative emphasis placed on social “flexibility” and “solidarity” can vary greatly without changing the fundamental nature of the economic system.<sup>12</sup> More generally, the appropriate scope of government activity remains an unsettled issue (Gutián, 1992 and 1996).

While acknowledging the relative—and invariably subjective—nature of any assessment of governance, it is still useful to attempt to define as explicitly as possible (and, if necessary, in a restrictive manner) the norms that could be used for such an assessment in an economic context. The capacity to ensure credible economic security provides an important and relevant, though by no means exclusive, benchmark against which economic governance can be evaluated. The core of good economic governance is a rule-of-law system in which the three conditions, indicated above, effectively hold. This benchmark has the advantage of minimizing potential conflicts in the choice of criteria: by only focusing on a set of minimum conditions for the effective functioning of a market economy, a broad-based and all-encompassing judgement on “good” governance becomes unnecessary, thereby obviating the need for insisting on the modification of broader social values and the risk of colonialism by virtue. Policy judgements and, subsequently, prescriptions can be reduced to relatively straightforward choices involving the efficiency of markets rather than complex and insoluble issues of comparative moral superiority.

---

<sup>11</sup> As President Madison said, “if men were angels, no government would be necessary,” cited in *The Federalist*, 1937.

<sup>12</sup> France, Japan, Sweden and the United States are all market-based capitalist economies, but with varying degrees of internal socio-political flexibility and solidarity reflected in their rules.

Other aspects of governance have important implications for the functioning of economic systems and, consequently, for growth. They include: the protection of specific groups in society for either moral or hierarchical reasons (e.g., the poorest or most vulnerable) or because they provide the power base for the governors (e.g., the military, or urban dwellers); and deliberate policy choices regarding broad social issues, such as protection of the environment. Social values attached to these aspects of governance may, and usually do, nuance assessments of governance based on hard-core economic criteria—they could significantly impact economic choices and might conflict with the efficiency requirements of policies designed to foster rapid growth.

“Bad” governance is often identified with corruption. In some ways, this amalgam is warranted; in other ways, it is confusing and simplistic. Bad governance and corruption have a common characteristic: they both express a deviation from a norm of behavior. Bad governance, however, refers to systemic concerns while corruption designates individual misbehavior. First, a useful aspect of this distinction is that it helps avoid errors in diagnoses (and in policy prescriptions)—such as those that occur when certain behavior is taken as evidence of corruption, but when, in fact, it demonstrates a social order with different notions of governance. For example, a head of state (or government or state enterprise, for that matter) who would be labeled “corrupt” for behaving along patriarchal lines by assigning himself public funds (say, from major state enterprises or from foreign contracts) could be exhibiting a systemic problem; thus, his behavior may be perfectly consistent in the context of the prevailing system. In such a case, the system itself is in need of change if the norms of good governance, defined above, are to prevail. Second, the distinction serves to highlight an important difference in nature and impact: corruption entails a cost similar to that of a tax, while bad governance raises uncertainty. Thus, while corruption is not justifiable, bad governance goes much further. In general, the costs levied on an economy through corruption are likely to be relatively less damaging to growth than those resulting from the uncertainty attached to a systemic absence of economic security. This understanding is also reflected in the point that corruption is an individual’s way around a distrust of government (Stiglitz, 1989 and 1996).

## V. SOME LESSONS

The foregoing discussion sheds light on the approaches that can be pursued, either from within a country or from outside, to encourage the transition to market-based economies. The primary argument is that focusing on the provision of a secure economic environment provides an effective and constructive way to address the issues of governance and corruption.

An early requirement in the path to a market economy is that a structure of authority needs to be established which has a vested interest in the prosperity of that economy. This structure of state authority needs to behave—and should clearly be perceived to behave—as a “stationary bandit” rather than a “roving” one (in Olson’s interestingly descriptive phrasing,

1993). Both have the power to tax or acquire income streams generated by private agents, but the former develops over time an incentive to generate private prosperity in the region. The “roving bandit” possesses little incentive to conserve and build the sources of prosperity since what he does not take, others will. Thus, it becomes critical to find out how the structure of incentives can be modified so that self-interest encourages the authority in place to foster prosperity in the region by using private resources in ways that are consistent with the objectives of the contributors, and to signal his commitment to do so. In an excellent presentation, Bates (1996) has shown how the development of appropriate political institutions can help this process.

Second, assuming the prevalence of a “stationary bandit”, there is a need for institutions (domestic or external) which can restrain the government’s discretionary powers and be instrumental in establishing the rule of law. These “agencies of restraint”, as Collier (1996) designates them, function either by imposing sanctions in the case of misbehavior or by assuming some of the powers originally vested in governments. In the economic area, some examples of such agencies are independent central banks and regional or international organizations; in fact, the exercise of conditionality by the international financial community is one of the ways available to governments to fulfill the functions of “agencies of restraint”. In the same way, the edification of a solid bureaucracy à la Colbert’s France is one of the possibilities open to enforce the rules and to acquire credibility; but bureaucracies themselves need to change in the transition to market systems until they rest on “arms-length” relationships (Tanzi, 1994).<sup>13</sup> This requires that the rules of government should be clearly laid out; civil servants wages must be competitive relative to the private sector; judicial courts must function independently; transparency of both rules as well as decisions must be a priority; and accountability and public accounting are as essential today, and for the same reasons, as it was in Colbert’s time—as an implicit check on the arbitrary behavior of rulers.

Third, inasmuch as the sanctity of contracts is a key component of a secure economic environment, “good” governance must be based on the notion that market creditworthiness—both domestic and external—needs to be deliberately constructed through appropriate financial policies. The penalties inflicted in the form of poor credit ratings, high domestic inflation, or high domestic real interest rates are ways in which the financial markets contribute to the enforcement of the rule of law. To avoid moral hazard, external financial assistance and especially debt forgiveness should be closely linked to adjustment policies that promote the future security of contracts. Of course, the same holds true in a purely domestic context. The overall purpose of adjustment policies is to generate and attract investment, both domestic and foreign, not to deter it.

---

<sup>13</sup> As an early exhortation to good behavior by bureaucrats, the Declaration of the Rights of Man and of Citizen”, Article XV stated: “Society has the right to demand accountability from every civil servant of the administration.” (Paris, 1789) The design of “corruption-proof” bureaucracies is in itself a lively analytical field and outside the scope of this paper (Asilis and Juan-Ramon, 1994; Shleifer and Vishny, 1993).

Fourth, in encouraging the transition to a market economy, discussions of governance can be constructive if they are carefully targeted. An emphasis on the creation and maintenance of a secure economic environment provides an effective way of addressing the issues of governance and corruption because this focus is likely to gain broad acceptance today; it relegates to the background those considerations on which any consensus is less likely to be attainable. In short, by not insisting on the linkage between the task of developing market-based security and broader issues of social change, it avoids a possible hazard of cultural imperialism, i.e., of going beyond the point where the state facilitates individual initiative to the stage where it becomes a “moral” institution (Hayek, 1944). It is vital not to confuse the rules of a market economy with the intellectual precepts of western civilization or with Christian ethics.<sup>14</sup>

On this basis, policy proposals aiming to ensure free entry, access to information, and enforcement of contracts in a rules-based system would rest on solid ground and constitute prescriptions for “good” governance in an economic sense.<sup>15</sup> Deviations from these norms (at some ideal, but perhaps inexistent, level of attainability) entail economic costs which may or may not be justified by specific socio-cultural values or similar factors. It is also conceivable that conflicts will arise between specific policy objectives and one or more of the conditions required for economic efficiency. This will lead to compromises; governments could opt for sub-optimal economic decisions which may be acceptable as second-best solutions. Whenever a policy decision implies a restriction on one of the three conditions (free entry, full information, security of contracts), possibilities for rent-seeking will arise and this—regardless of any morally acceptable outcome—will not be consistent with the maximization of returns in a market economy. In that case, a judgement can be made that society is willing to pay this economic cost. However, no moral judgements regarding the system or practice of governance are involved. Economic policy advice then becomes an exercise to demonstrate the extent of the cost involved and its implications for the well-being of present and future generations.

This approach can also help the constructive involvement of the international financial community in issues of governance. It is based on the logic that : the common effort to foster economic growth in an orderly way can be best achieved in market-based economies; such economies require a rules-based system to create a secure economic environment which encourages investment; thus, good governance consists of policy actions that promote such an

---

<sup>14</sup> Huntington (1993) emphasizes “the real and important differences among civilizations” and argues forcefully that these differences will increasingly supplant ideological or economic factors as primary reasons for future conflicts.

<sup>15</sup> There are, of course, some economic policy actions that will not directly improve growth performance but could be considered as “good” governance broadly defined, e.g., creation of an adequate social safety net, control over the quality of government expenditures, etc.

environment.<sup>16</sup> In a broad sense, any prescriptions that promote greater openness in economic policies and in the underlying systems will be a move in the right direction as far as good governance is concerned. Thus, policy advice from the international community should, *inter alia*, be directed towards: (a) encouraging the creation of rules that define a secure economic environment, e.g., central bank and commercial bank laws, bankruptcy laws, tax codes, laws dealing with property rights, customs tariff, business registration requirements, etc.; (b) promoting institutions that effectively implement the rules, e.g., civil service reforms, revenue collection agencies (World Bank, 1996); and (c) establishing data and information standards that generate transparency and accountability to ensure the continued existence of a secure environment. These are the benchmarks against which policy decisions and implementation should be judged. This does not mean that there are not other, perhaps broader, standards or benchmarks against which such decisions and actions can be judged or evaluated; but simply that it is neither necessary nor desirable for these broader approaches to be pursued in order to promote the process of the orderly economic growth of nations.

---

<sup>16</sup> This ignores the more common (but misleading) argument about not “wasting the funds of taxpayers in donor countries” by insisting on good governance.

## REFERENCES

- Agenor, Pierre Richard, "Credible Disinflation Program," *IMF PPAA 93/9*, July 1993.
- Alesina, Alberto, and Roberto Perotti, "Income Distribution, Political Instability, and Investment," *NBER Working Paper*, No. 4486. Forthcoming in *European Economic Review*.
- Asilis, Carlos M., and V. Hugo Juan-Ramon, "On Corruption and Capital Accumulation," *IMF Working Paper 94/85*, July 1994.
- Bates, Robert H., "Institutions as Investments," Plenary Paper presented at the AERC Biannual Research Workshop, May 25–30, 1996, Nairobi, Kenya.
- Barro, Robert, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics*, volume 106, 1991.
- Barro, Robert and Sala-i-Martin, Xavier, *Economic Growth*, McGraw-Hill, 1995.
- Borner, Silvio, Brunetti, Aymo, and Weder, Beatrice, *Political Credibility and Economic Development*, St. Martin's Press, 1995.
- Collier, Paul, *The Role of the State in Economic Development: Cross Regional Experiences*, Center for the Study of African Economies, mimeo, November 1996.
- Dornbusch, Rudiger, "Notes on Credibility and Stabilization", *National Bureau of Economic Research Working Paper* number 2790, 1988.
- European Bank for Reconstruction and Development, *Transition Report*, various issues, EBRD, London.
- Fabricius, Michael, "What Can Economic Security Tell Us About Saving and Investment," (Mimeo, first draft) October 1996, African Department, IMF.
- Frischtak, Leila and Atiyas, Izak (ed.), *Governance, Leadership, and Communication*, World Bank, 1996.
- Gutián, Manuel, "Scope of Government, and Limits of Economic Policy" in *Macroeconomic Dimension of Public Finance*, Blejer, Mario and Ter-Minassian, Teresa (ed.), London, Rowledge 1996.
- Gutián, Manuel, "Risks and Discretion in International Economic Policy," *IMF Occasional Paper no.97*, 1992.

Gyimah-Brempong, Kwabena, and Thomas L. Traynor, "Political Instability and Savings in Less Developed Countries: Evidence from Sub-Saharan Africa," *The Journal of Development Studies*, Vol. 32, No. 5, June 1996 (pp. 695-714).

Hadjimichael, M., and Dhaneshwar Ghura, "Public Policies and Private Savings and Investment in Sub-Saharan Africa: An Empirical Investigation," *IMF Working Paper 95/19*, February 1995.

Hayek, F.A., *The Road to Serfdom*, (Fiftieth Anniversary Edition) The University of Chicago Press, 1994.

Huntington, Samuel, "The Clash of Civilizations," *Foreign Affairs*, No. 72, Summer 1993.

IMF et al, *A Study of the Soviet Economy*, (three volumes) OECD, Paris 1991.

Keefer, Philip and Stephen Knack, "Why Don't Poor Countries Catch Up?," Working Paper 60, Center for International Reform and the Informal Sector, College Park, Maryland, July 1995, p. 18.

Lal, Deepak, and H. Myint, *The Political Economy of Poverty, Equity and Growth*, Clarendon Press, Oxford, 1996.

Lucas, Robert, "Principles of Fiscal and Monetary Policy", *Journal of Monetary Economics*, Vol. 17, January 1986.

Lucas, Robert, "Why Doesn't Capital Flow From Rich to Poor Countries", *American Economic Review*", Vol. 103, May 1990.

Mauro, Paolo, "The Effects of Corruption on Growth, Investment, and Government Expenditure," *IMF Working Paper 96/98*, September 1996.

Oakeshott, M., *Morality and Politics in Modern Europe*, Yale University Press, New Haven, Conn., 1993.

OECD, Development Assistance Committee, *DAC Orientations on Participatory Development and Good Governance*, Paris, December 1993.

Olson, Mancur, "Dictatorship, Democracy, and Development," *American Political Science Review*, Vol.87, No.3, September 1993.

Olson, Mancur, "Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others Poor," *Journal of Economic Perspectives*, Volume 10, Number 2, Spring 1996.

Rawls, John, *A Theory of Justice*, Harvard University Press, Cambridge, Mass., 1971.

Serven, Luis, "Irreversibility, Uncertainty and Private Investment: Analytical Issues and Some Lessons for Africa," The World Bank, May 1996. Paper prepared for the AERC Research Workshop, Nairobi, Kenya, May 1996.

Shleifer, Andrei "Government in Transition," Harvard Institute for Economic Research, Discussion Paper, Number 1783, October 1996.

Shleifer, Andrei and Robert W. Vishny, "Corruption," *Quarterly Journal of Economics*, Vol. CVIII, August 1993.

Stiglitz, Joseph, "On the Economic Role of the State", in *The Economic Role of the State*, A. Heertje (ed.), Basil Blackwell, Oxford, 1989.

Stiglitz, Joseph, *Whither Socialism?*, MIT Press, Cambridge, Mass. 1994.

Stiglitz, Joseph, "The Role of Government in Economic Development," paper delivered at the Annual Bank Conference on Development Economics, World Bank, Washington D.C. April 25–26, 1996.

Tanzi, Vito, "Corruption, Governmental Activities, and Markets," *IMF Working Paper 94/99*, August 1994.

Weber, Max, *Economy and Society*, Vol. II, University of California Press, Berkeley, 1978.

World Bank, *World Development Report 1996: From Plan To Market*, World Bank, Washington D.C., 1996.