INSTITUTIONS, GLOBALISATION and EMPOWERMENT

Edited by

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Preface

In all societies, systems based on social norms or networks – alternatively referred to as informal institutions and sometimes referred to as 'culture' – are a central means of facilitating economic transaction, social behaviour and interaction.

In all developing countries such norm-based institutions are very important for the poor, who often lack formal alternatives. Informal rules and regulations are obeyed by people – both poor and non-poor – because there is a penalty for social action. The informal institutions also supplement or supplant laws and formal rules. But sometimes both informal and formal institutions need to be amended for the society and the market economy to function better. Sometimes, when some social and economic practices become discriminatory, the relevant societal norms may have to be explicitly supplanted rather than amended. Many successful institutional arrangements have flourished in many countries because of their ability to harness or adapt to prevailing norms. Hence building bridges between existing formal and informal institutions is an effective means of ensuring the success of government efforts to achieve human and economic development. However, since the early 1990s, international formal rules and regulations have been greatly influencing the formal and informal institutions within each country. Therefore there is now the need for every country to build bridges between domestic and international institutions.

This volume examines at the theoretical and empirical level, the role of informal and formal institutions in development in a number of selected countries, and how the forces of globalisation are influencing the domestic social and economic institutions and thereby the process of empowerment of people in these countries. Some chapters included in this volume were previously published as papers in refereed international journals. The other chapters were independently reviewed before being included in this volume.

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PART I

Introduction

1. Institutions, globalisation and empowerment: an overview of issues

Kartik C. Roy and Jörn Sideras

INTRODUCTION

Since the early 1990s, the crucial role played by institutions in the process of economic development, and in explaining global difference in development outcomes, has gained increasing attention from academia, policymakers and international financial institutions. During the 1950s and 1960s, investments in physical capital and infrastructure were seen as the essential stimuli for economic development. The emphasis during the 1970s shifted to investment in human capital as it is considered to be one of the most fundamental requirements in the achievement of development outcomes. But during the course of the 1980s and 1990s the centre of focus shifted to enhancing economic management through a greater play of market forces within and between countries. In line with this development in thinking over the last two decades, policy has focused on the liberalisation of product and factor markets within countries and also a thrust towards the dismantling of trade barriers and barriers preventing the free flow of funds between countries in an attempt towards globalisation.

However, the issue as to whether globalisation has been successful in reducing inter- and intra-country income inequality has recently emerged as a hotly debated topic.[1] While the jury is still out in this debate, the fact remains that despite the provision of massive financial resources and the prescription of well-meaning policies to improve investment in human and physical capital and the adoption of market-orientated policies, the results have been in many countries disappointing. A consensus now exists that if resources and policies are to be effective in achieving the desired outcome of economic development, it is essential that the plethora of institutions that exist in a country are conducive to ensuring that the objectives are achieved. Without appropriate institutions and facilitating interrelationships among them, resources and policies aimed at achieving economic development will be frustrated. There is widespread agreement among

researchers, policymakers and international financial institutions that institutions do 'matter' in delivering economic growth and reducing poverty.

WHAT ARE INSTITUTIONS?

Following North (1990), institutions are generally viewed as rules or constraints that societies construct to control or enhance human interaction. Two types of institutions are considered as essential for economic development: those that lower transactions costs in cooperation, dispute resolution and trade and those that make it mandatory for the state to protect property rights through formal rules that ensure contracts are enforced.

The rules or constraints that govern the interaction of individuals or organisations may be formal or informal. Formal rules include constitutions, laws, property rights, charters, by-laws, statute and common law, regulations and enforcement characteristics like sanctions. Informal rules extend, elaborate and modify formal rules, control behaviour through social norms (customs, taboos and traditions), and internally enforce standards of conduct (Jutting, 2003).

While both rich and poor countries use formal and informal rules to facilitate transactions, poor countries have less developed formal institutions or are ill served by the limited formal institutions that do exist. In such situations, informal institutions substitute for formal ones. But informal institutions are considered as crucial in the development process since the same formal rules imposed on different societies produce varied results. Further, while shock treatment may be used to alter formal rules and institutions, informal institutions like social norms, customs, taboos, and traditions that act against economic development take a much longer time to change and cannot be changed easily through legislation or any deliberate policies.

Theoretical developments, empirical evidence, and common sense affirm that institutions do matter for development and there is widespread agreement among analysts, policymakers and international financial institutions regarding the crucial role of institutions in economic development. But there is less agreement on how to categorise institutions. Using the North (1990) classification, international financial institutions like the World Bank categorise institutions as formal or informal and devise policies based on this dichotomy (World Bank, 1996, 2000, 2001, 2002 and 2003).

However, institutions can be classified not only in terms of their degree of formality but also according to different levels of hierarchy. Williamson (2000) proposes four interconnected hierarchical levels. These are institutions related to the social structure of society, to the rules of the game, to the

play of the game, and to the allocation mechanism. Institutions related to the social structure of society are the ones that North describes as informal institutions and are the ones least prone to change except at times of shock or crisis. While stressing the importance of informal institutions in relation to the time it takes for change to take place, Williamson points out that institutions relating to the rules of the game and to the play of the game are also relatively impervious to change even though these are formal in nature.

Another classification strategy used in the literature relates to the area of influence of institutions. Institutions can be categorised into four areas of analysis: economic institutions, political institutions, legal institutions and social institutions. Economic institutions are those rules that govern the production, allocation and distribution of goods and services; political institutions deal with the election process and electoral system, type of political system, composition of government and opposition, and political stability; legal institutions comprise the type of legal system and rules governing the enforcement of property rights; and social institutions are those rules that relate to the provision of health care, education, social security and gender balance.

Whatever classification strategy is adopted, the concern is to investigate how institutional outcomes influence development outcomes. But the influence may not be unidirectional. Development outcomes can and do influence institutional outcomes as well. Recognising this, Jutting (2003) categorises institutions on the basis of endogeneity and exogeneity. Exogenous institutions are those rules that are independent from changes in the development outcome. Those institutions that can change as a result of development outcomes are classified as endogenous.

EMPIRICAL STUDIES OF EFFECTS OF INSTITUTIONS ON DEVELOPMENT

Two types of empirical studies have been undertaken to investigate the impact of institutions on development outcomes: cross-sectional studies and country case studies. Cross-sectional studies (for example Beck et al., 2002; Easterly, 2001; Aron, 2000; La Porta et al., 1998) attempt mainly to explain the impact of institutions on growth rates, government performance and corporate structures. While most cross-sectional studies agree that institutional quality does matter for growth, they are ambiguous in relation to the relative importance of institutions *vis-à-vis* other factors like geography and trade.

Country case studies by their very nature are more specific and more useful in terms of formulating reform policies in particular countries.

Country case studies (for example Becker, 2003; Heltberg, 2001; Nermarunde and Kozanayi, 2002; Lohlein et al., 2003; Pamuk, 2000; Chaudhuri, 1996) generally view institutions in the North sense, stressing the importance of informal institutions and the desirability of linking formal and informal rules. Country case studies of the impact of institutions on development can be categorised under the topics natural resource management, market development and conflict management (Jutting, 2003).

EXISTENCE OF WEAK INSTITUTIONS

Various explanations have been offered in the literature regarding the reasons for the existence of weak institutions that frustrate policy actions aimed at economic development. Weak institutions are explained as resulting from informal norms, colonial heritage, factor endowments and political conflict.

The divergence of cultural beliefs, according to Greif (1994), can explain the divergence in the organisation of society and the existence of more informal institutions in some societies. Differences in the efficiency of institutions have also been attributed to differences in factor endowments. In those countries where an abundance of natural resources existed and the native population was sparse, colonisers were able to establish a plethora of institutions largely to insure their dominance. While the factor endowment argument seems to work for the Americans, it does not provide a convincing argument for the existence of political and economic institutions in Africa.

With regards to Africa, some writers (for example Bates, 2001) argue that the existence of weak institutions is due to the lack of conflict, historically, over boundaries and trade. Such conflicts and the need for reconstruction in cases of serious conflict are seen as responsible for the economic development of Western Europe.

Other writers, notably North (1990), have suggested that weak institutions in some former colonies are due to their colonial heritage. North argues that Latin America inherited weak institutions as a result of its colonisation by Spain while the United States and Canada benefited from their English heritage. It can be argued that the effects of colonial heritage on legal institutions and therefore on financial institutions and economic development are shaped by historically determined differences in legal tradition which influence how societies protect property rights and enforce contractual agreements. These differences shape the attitudes of savers and investors, corporate culture, and the degree of financial market development.

GLOBALISATION

However, the influence of historically determined institutions in each country on its economic, social, political and legal systems and on human lives remained considerable as long as there were restrictions on the movement of capital, labour, information and culture between countries. Under globalisation, these restrictions have now been considerably removed. As a result, institutions in each country can no longer remain insulated from the influence of global institutions. Accordingly, a country's economic, social, political and cultural development are now conditioned by the forces of domestic as well as global institutions.

While the growing integration of economies and societies in the world is a complex process that affects many aspects of our lives, the integration would not have been feasible without a wide range of domestic reforms covering governance, investment and environment, provision of social services and so on. However, there are both winners and losers from globalisation. Both owners of firms and workers in protected sectors are likely to lose from liberalisation and a more competitive economy, whereas consumers and those who find jobs in new firms will be among the winners. It is important to counter the risk of loss with the social protection which can now be provided due to economic gains that the countries under globalisation have been experiencing.

However, since globalisation influences all domestic institutions, opinions around the world reveal a concern that economic integration will lead to cultural or institutional homogenisation. But our experience shows that even societies that have been fully integrated into the global economy differ enormously. Among the richest countries, Japan and America differ from each other in terms of culture, institutions, social policy and inequality.

On the other hand, developing countries which have also been integrated into the global economy, for example India, China and Thailand, have retained the diversity of their culture and institutions (World Bank, 2002). The diversity in institutions among countries appears to be more prominent than is commonly thought. Some recent developments in the global trading and investment regime have been influencing the countries to accept standardisation in terms of economic rules and regulations. Although it is important to ensure that global trade and investment agreements allow individual countries to retain their decision-making power in respect of property rights, cultural goods, social policies, environmental protection and so on, there is also the need for sociocultural institutions to shed some of their old practices which act as a powerful deterrent to the empowerment of the poor and the weak in all poor countries. Since these institutions set the parameters within which the empowerment of the weak

can be achieved, it would be to the advantage of the country to facilitate the liberalisation of the customary rules and regulations by adopting global norms in sociocultural customs and practices. Since those who are benefiting from the global economic integration are adopting some global rules to transform their economic institutions, they also need to modify their cultural and social institutions in order to achieve success in poverty reduction. One has to note here that poverty does not have an economic dimension, but it does have a considerable cultural dimension. Hence addressing issues in poverty would require addressing the cultural dimension of poverty.

In that respect, globalisation does and will pose cultural challenges. But it would be to the advantage of a developing country to accept these challenges, as the greater diversity in culture and social tradition created with the interaction of foreign cultures and people can enrich local societies and culture. Since, in developing countries, culture consisting of many centuries-old customs, traditions and taboos poses the greatest hindrance to their development, foreign culture and the sheer pace of economic change may threaten to displace local culture. But for a developing country to derive the full benefit from its integration into the global economy, it needs to shed some aspects of its culture which are not conducive to economic growth and development as well as absorb these aspects of foreign culture which are pro growth and development. Global growth can also threaten the environment. Hence pollution issues require local legislation as well as global rules. For anything new that emerges – a new system of production, consumption or governance – there will be both beneficial and adverse effects. For the first time in the international economy, a global society has emerged. It can provide a powerful stimulus to global collective action for improving the living standards of the global population, for limiting the damage to the environment, and for reducing poverty (World Bank, 2001).

The most fundamental question that still remains to be answered is, will the institutional reforms enforced on the globalisers by the forces of globalisation help them to reduce the level of poverty? Will the world's poorest, the 1.2 billion people who still live on less than $1 a day, share in the benefits offered by globalisation? A recent World Bank study (Dollar and Kraay, 2001) suggests that the countries that have opened themselves to trade in the last two decades have, on average, grown the fastest. These 'new globalisers' among developing countries have reduced import tariffs, on average by 34 percentage points since 1980, compared with only 11 percentage points for those developing countries that, on average, saw no growth in per capita income over the period. Dollar and Kraay identify 24 developing countries including China, India, Mexico and Thailand that have seen large increases in openness, characterised by a rising share of trade in GDP

achieved per capita, and growth rates that were 4 per cent higher than those of non-globalising countries in the 1990s. With regard to the impact of this growth on poverty alleviation, it is argued that since increased trade is not associated, in general, with a systematic tendency to increased inequality, even if the poor maintain their share of growth in proportion to their existing share of national income, a higher growth rate unaccompanied by any change in income distribution has to translate into a reduction in poverty level at a more rapid rate.

But this argument appears to be based on the implicit assumption that trade liberalisation is responsible for successful integration which ipso facto helps a globaliser achieve success in attaining faster growth and poverty reduction (Watkins, 2002). Unfortunately, however, the experience of Latin American countries tells a different story. Latin America's unbridled openness to trade was appreciated by the West but its effect on poverty reduction has been disastrous. The level of income inequality has worsened. The number of people below the $1-a-day poverty-line income ran into many more millions at the end of 1990s than in the late 1980s. Substantial inflows of cheap and subsidised imports of food virtually destroyed subsistence agriculture which undermined the capacity of poor to earn their livelihood and thereby worsened their pre-existing poverty level, whereas the large-scale commercial farmers engaged in plantation agriculture increased their income from cash crop exports thereby further accentuating the pre-existing extreme income inequalities.

Furthermore, the integration of these and other countries into the global market has increased the intensity of gender deprivation because while a large number of women are obtaining employment and higher wages, under globalisation, the flexibilisation of the labour market has increased the exploitation of female labour and increased their vulnerability to labour market shocks, such as the absence of job security.

Hence, under this situation, instead of reducing the level of poverty, if globalisation increases the level of poverty, then the chances of the poor attaining empowerment recede further and further.

However, it is argued that other globalisers in East Asia, such as China, Thailand, Malaysia and Vietnam, have achieved high growth and good results in their poverty reduction efforts – so globalisation cannot be entirely blamed for the problem that Latin America is facing. On the other hand, in a vast country like India, which has been a new globaliser since 1991, the presence of gender discrimination and deprivation predates India's integration with the global economy by many centuries. After 'Green Revolution' technology was introduced to Indian agriculture, landless rural women initially suffered more from rising unemployment, gender discrimination and deprivation than before. But India's rural sector is

dominated by small-scale family farmers, primarily producing food and other staple products for their own sustenance. The longer-term impact of cheaper subsidised food imports from rich countries on India's farmers has not been perceptibly high. The substantial increase in information flows into India from the rest of the world under globalisaton has been slowly helping to weaken the forces of gender discrimination and deprivation. Poverty levels in India have been consistently falling since the growth rate began to accelerate in the mid 1980s. The question arises why for some globalisers such as India, China and Southeast Asia, increased openness to trade has led to higher economic growth and poverty reduction, whereas for Latin American globalisers such as Brazil, Mexico, Argentina and Peru, the result has been disastrous for poverty reduction and subsequent empowerment.

The answer may lie in differences in their approaches to institutional reform and globalisation, as well as in levels of inequality in income distribution in these two regions. While Latin America adopted a 'big bang' approach to trade liberalisation by virtually removing most restrictions on imports, Southeast Asia, China and India adopted a 'gradualist' approach by liberalising import trade slowly while promoting export trade vigorously.

Institutional reforms relating to trade liberalisation have proceeded at a slower rate in India than in Southeast Asian countries. The average rate of tariff is still considerably higher in India than in China and Southeast Asia. As a result, while India's integration into the global economy has proceeded at a relatively slower rate, this has also helped it to keep its current account deficit at a relatively lower level than in Southeast Asian countries. While import trade liberalisation has decimated subsistence agriculture in Latin America, the maintenance of reasonable import restrictions has prevented the collapse of smallholder agriculture in India, the rest of South Asia, Indonesia, Thailand, Philippines and Vietnam. There has been far less inequality in income distribution in South and Southeast Asia than in Latin America, as illustrated in Table 1.1.

Table 1.1 shows that far greater equality in the distribution of income has been achieved in South Asian countries than in Latin American and African countries. Among the Southeast Asian countries, Indonesia and Vietnam have shown better results in income distribution than other countries. This is primarily due to the fact that the rural sector in all these countries is dominated by smallholder agriculture producing staple crops for the sustenance of rural populace. Although the population growth is higher in the rural sector than in the urban sector, technological changes in agriculture have increased the output and prevented the income distribution from becoming more unequal. In Latin America and Africa the rural sector is dominated by large-scale plantation companies, which has led to a greater

Table 1.1 Distribution of income in selected countries

Country	Survey year	Percentage share of income	
		Lowest 20%	Highest 20%
South Asia			
India	1992	8.5	42.6
Pakistan	1991	8.4	39.7
Bangladesh	1992	9.4	37.9
Sri Lanka	1990	8.9	39.3
East Asia			
China	1995	5.5	47.5
Philippines	1988	6.5	47.8
Thailand	1992	5.6	52.7
Vietnam	1993	7.8	44.0
Indonesia	1993	8.7	40.7
Latin America			
Mexico	1992	4.1	55.3
Columbia	1991	3.6	55.8
Brazil	1989	2.1	67.5
Peru	1994	4.9	32.9
Chile	1994	3.5	61.0
Africa			
South Africa	1993	3.3	63.3
Kenya	1992	3.4	62.1
Zambia	1993	3.9	50.4
Zimbabwe	1990	4.0	62.3

Source: World Bank (1997).

concentration of wealth in fewer hands. Furthermore, poverty reduction and subsequent empowerment of the poor would also require the application of measures to redistribute land, to increase investment in marketing infrastructure, to improve access to education and health care and to keep the level of corruption to a minimum (Watkins, 2002).

EMPOWERMENT

Current literature on development studies (Stern, 2002; World Bank, 2000; Narayan, 2002; Roy and Tisdell, 1992; Roy and Tisdell, 1993; Roy, 1994; Roy and Tisdell, 1996; Vechhio and Roy, 1998; Roy and Chai, 2004; Roy

and Blomqvist, 2004), and our own experience during field studies in the rural hinterlands of India suggest the presence of a strong link between empowerment, growth and poverty reduction. Growth cannot ensure poverty reduction on a sustainable basis, unless growth is accompanied by greater equality in the distribution of income. On the other hand, poverty reduction on a sustainable basis is the most essential prerequisite to attaining empowerment.

Empowerment in broad terms means expansion of freedom of choice and action to shape one's life. It implies a person's effective control over resources and decisions. In developing as well as in developed countries, the capacity of extremely poor people to exercise their decisionmaking power and effective control over resources is limited by their powerlessness to negotiate fair deals for themselves with the state, market and society. Because powerlessness is inbuilt in a culture of unequal institutional relations, empowering the poor requires the removal of formal and informal institutional barriers that prevent them from taking action to expand their assets and capabilities to improve their wellbeing (Narayan, 2002). The institutional reform would require: (1) public access to information; (2) people's participation in decisionmaking as partners, with authority and control over decisions and resources; (3) accountability of the state apparatus and other agents to the people for their policies and actions; and (4) the capacity of people to organise themselves and to mobilise resources to solve problems of common interest.

Even in poor countries, public access to information has become easier under globalisation. Information flow from the governments, and particularly from the rest of the world, has increased phenomenally since the early 1990s. Institutional reforms undertaken by countries in the developing world by considerably increasing economic growth rates and enhancing the prospects of further rises in growth rates have been creating greater opportunities for market activities and employment generation, for poverty reduction, for public participation in decisionmaking processes regarding the production, distribution and consumption of goods and services, and for making the state and private sector officials accountable to the people for their actions.

Hence, the link is clearly established between globalisation, institutions, poverty reduction and empowerment. Globalisation helps a country achieve higher economic growth by undertaking appropriate institutional reforms. This higher growth enables the country to create opportunities for employment of the poor and also the better-off in the country. The income generation activities in their turn, by alleviating poverty, facilitate the empowerment of people including those who are poor.

CONCLUDING REMARKS

Thus it appears that issues involving institutions, globalisation and empowerment are interconnected. Apart from dealing with theoretical aspects of these issues in this volume, we shall examine individual aspects of these issues in countries in all five continents. The ultimate objective of development in all countries is to empower people. Historically, even when the forces of globalisation were not so strongly present in the global arena, institutions remained the vital force for guiding development processes and empowering people. But now globalisation has, in fact, been helping the society and the state to incorporate some changes in their social institutions to carry forward the agenda for development with renewed vigour.

NOTE

1. See for example Dollar and Kraay (2001), Lee (2002), Sala-I-Martin (2002).

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PART II

Concepts

2. Institutions for high-quality growth: what they are and how to acquire them*

Dani Rodrik

Sakenn pe prie dan sa fason
(Everyone can pray as he likes.)

Mauritian folk wisdom[1]

INTRODUCTION

This chapter opens with a discussion of the types of institutions that allow markets to perform adequately. While we can identify in broad terms what these are, there is no unique mapping between markets and the non-market institutions that underpin them. The chapter emphasises the importance of 'local knowledge', and argues that a strategy of institution building must not over-emphasise best-practice 'blueprints' at the expense of experimentation. Participatory political systems are the most effective ones for processing and aggregating local knowledge. Democracy is a meta-institution for building good institutions. A range of evidence indicates that participatory democracies enable higher-quality growth.

The comparative experience with economic growth over the last few decades has taught us a number of important lessons. One of the more important of these is the importance of private initiative and incentives. All instances of successful development are ultimately the collective result of individual decisions by entrepreneurs to invest in risky new ventures and try out new things. The good news here is that we have found *homo economicus* to be alive and well in the tropics and other poor lands. The idea of 'elasticity pessimism' – the notion that the private sectors in developing countries would fail to respond quickly to favourable price and other incentives – has been put to rest by the accumulating evidence. We find time and again that investment decisions, agricultural production, or exports turn out to be quite sensitive to price incentives, as long as these are perceived to have some predictability.

The discovery that relative prices matter a lot, and that therefore neoclassical economic analysis has much to contribute to development policy, led for a while to what was perhaps an excessive focus on relative prices. Price reforms – in external trade, in product and labour markets, in finance, and in taxation – were the rallying cry of the reformers of the 1980s, along with macroeconomic stability and privatisation. By the 1990s, the shortcomings of the focus on price reform were increasingly evident. The encounter between neoclassical economics and developing societies served to reveal the institutional underpinnings of market economies. A clearly delineated system of property rights; a regulatory apparatus curbing the worst forms of fraud, anti-competitive behaviour, and moral hazard; a moderately cohesive society exhibiting trust and social cooperation; social and political institutions that mitigate risk and manage social conflicts; the rule of law and clean government – these are social arrangements that economists usually take for granted, but which are conspicuous by their absence in poor countries.

Hence it became clear that incentives would not work or would generate perverse results in the absence of adequate institutions. Some of the implications of this were recognised early on, for example in discussions on rent seeking in the trade policy context (where corruption was the main issue) or in the discussions on common-property resources (where lack of adequately defined property rights was the problem). But the broader point that markets need to be supported by non-market institutions in order to perform well took a while to sink in. Three sets of disparate developments conspired to put institutions squarely on the agenda of reformers. One of these was the dismal failure in Russia of price reform and privatisation in the absence of a supportive legal, regulatory, and political apparatus. A second is the lingering dissatisfaction with market-oriented reforms in Latin America and the growing realisation that these reforms have paid too little attention to mechanisms of social insurance and to safety nets. The third and most recent is the Asian financial crisis, which has shown that allowing financial liberalisation to run ahead of financial regulation is an invitation to disaster.

The question before policy makers therefore is no longer 'do institutions matter?'[2] but 'which institutions matter and how does one acquire them?' Following Lin and Nugent (1995: 2306–7), it is useful to think of institutions broadly as 'a set of humanly devised behavioural rules that govern and shape the interactions of human beings, in part by helping them to form expectations of what other people will do'. I begin this article with a discussion of the types of institutions that allow markets to perform adequately. While we can identify in broad terms what these are, I shall argue that there is no unique mapping between markets and the non-market

institutions that underpin them. The plausible variation in institutional setups is larger than is usually presupposed.[3]

I then turn to the more difficult question of how one thinks about appropriate strategies for institution building. I emphasise the importance of 'local knowledge', and argue that a strategy of institution building must not overemphasise best-practice 'blueprints' at the expense of local experimentation. I make the case that participatory and decentralized political systems are the most effective ones we have for processing and aggregating local knowledge. We can think of democracy as a meta-institution for building good institutions.

The penultimate section of the chapter provides a range of evidence indicating that participatory democracies enable higher-quality growth: they allow greater predictability and stability, are more resilient to shocks, and deliver superior distributional outcomes. The concluding section offers some implications for the design of conditionality.

WHICH INSTITUTIONS MATTER?

Institutions do not figure prominently in the training of economists. The standard Arrow–Debreu model with a full set of complete and contingent markets extending indefinitely into the future seems to require no assistance from non-market institutions. But of course this is quite misleading even in the context of that model. The standard model assumes a well-defined set of property rights. It also assumes that contracts are signed with no fear that they will be revoked when it suits one of the parties. So in the background there exist institutions that establish and protect property rights and enforce contracts. We must, in other words, have a system of laws and courts to make even 'perfect' markets function.

Laws in turn have to be written and they have to be backed up by the use of sanctioned force. That implies a legislator and a police force. The legislator's authority may derive from religion, family lineage, or access to superior violence, but in each case she needs to ensure that she provides her subjects with the right mix of 'ideology' (a belief system) and threat of violence to forestall rebellion from below. Or the authority may derive from the legitimacy provided by popular support, in which case she needs to be responsive to her constituency's (voters') needs. In either case, we have the beginnings of a governmental structure that goes well beyond the narrow needs of the market.

One implication of all this is that the market economy is necessarily 'embedded' in a set of non-market institutions. Another is that not all of these institutions are there to serve the needs of the market economy first

and foremost, even if their presence is required by the internal logic of private property and contract enforcement. The fact that a governance structure is needed to ensure that markets can do their work does not imply that the governance structure serves only that end. Non-market institutions will sometimes produce outcomes that are socially undesirable, such as the use of public office for private gain. They may also produce outcomes that restrict the free play of market forces in pursuit of a larger goal, such as social stability and cohesiveness.

The rest of this section discusses five types of market-supporting institutions: property rights; regulatory institutions; institutions for macroeconomic stabilisation; institutions for social insurance; and institutions of conflict management.

Property Rights

While it is possible to envisage a thriving *socialist* market economy in theory, as Oskar Lange established in the famous debates of the 1920s, today's prosperous economies have all been built on the basis of private property. As North and Thomas (1973) and North and Weingast (1989), among many others, have argued, the establishment of secure and stable property rights has been a key element in the rise of the West and the onset of modern economic growth. It stands to reason that an entrepreneur would not have the incentive to accumulate and innovate unless s/he has adequate *control* over the return to the assets that are thereby produced or improved.

Note that the key word is 'control' rather than 'ownership'. Formal property rights do not count for much if they do not confer control rights. By the same token, sufficiently strong control rights may do the trick even in the absence of formal property rights. Russia today represents a case whereby shareholders have property rights but often lack effective control over enterprises. Township and village enterprises (TVEs) in China are an example in which control rights have spurred entrepreneurial activity despite the absence of clearly defined property rights. As these instances illustrate, establishing 'property rights' is rarely a matter of just passing a piece of legislation. Legislation in itself is neither necessary nor sufficient for the provision of the secure control rights. In practice, control rights are upheld by a combination of legislation, private *and* public enforcement, and custom and tradition. They may be distributed more narrowly or more diffusely than property rights. Stakeholders can matter as much as shareholders.

Moreover, property rights are rarely absolute, even when set formally in the law. The right to keep my neighbour out of my orchard does not normally extend to my right to shoot him if he actually enters it. Other laws or

norms – such as those against murder – may trump property rights. Each society decides for itself the scope of allowable property rights and the acceptable restrictions on their exercise. Intellectual property rights are protected assiduously in the United States and most advanced societies but not in many developing countries. On the other hand, zoning and environmental legislation restricts the ability of households and enterprises in the rich countries to do as they please with their 'property' to a much greater extent than is the case in developing countries. All societies recognise that private property rights can be curbed if doing so serves a greater public purpose. It is the definition of what constitutes 'greater public purpose' that varies.

Regulatory Institutions

Markets fail when participants engage in fraudulent or anti-competitive behaviour. They fail when transaction costs prevent the internalising of technological and other non-pecuniary externalities. And they fail when incomplete information results in moral hazard and adverse selection. Economists recognise these failures and have developed the analytical tools required to think systematically about their consequences and possible remedies. Theories of the second best, imperfect competition, agency, mechanism design, and many others offer an almost embarrassing choice of regulatory instruments to counter market failures. Theories of political economy and public choice offer cautions against unqualified reliance on these instruments.

In practice, every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in goods, services, labour, assets, and financial markets. A few acronyms from the US will suffice to give a sense of the range of institutions involved: FTC, FDIC, FCC, FAA, OSHA, SEC, EPA, and so on. In fact, the freer are the markets, the greater is the burden on the regulatory institutions. It is not a coincidence that the United States has the world's freest markets as well its toughest anti-trust enforcement. It is hard to envisage in any country other than the United States a hugely successful high-tech company like Microsoft being dragged through the courts for alleged anti-competitive practices. The lesson that market freedom requires regulatory vigilance has been driven home recently by the experience in East Asia. In South Korea and Thailand, as in so many other developing countries, financial liberalisation and capital-account opening led to financial crisis precisely because of inadequate prudential regulation and supervision.[4]

It is important to recognise that regulatory institutions may need to extend beyond the standard list covering anti-trust, financial supervision, securities regulation, and a few others. This is true especially in developing

countries where market failures may be more pervasive and the requisite market regulations more extensive. Recent models of coordination failure and capital market imperfections[5] make it clear that strategic government interventions may often be required to get out of low-level traps and elicit desirable private investment responses. The experience of South Korea and Taiwan in the 1960s and 1970s can be interpreted in that light. The extensive subsidisation and government-led coordination of private investment in these two economies played a crucial role in setting the stage for self-sustaining growth (Rodrik, 1995). It is clear that many other countries have tried and failed to replicate these institutional arrangements. And even South Korea may have taken a good thing too far by maintaining the cozy institutional linkages between the government and *chaebols* well into the 1990s, at which point these may have become dysfunctional. Once again, the lesson is that desirable institutional arrangements vary, and that they vary not only across countries but also within countries over time.

Institutions for Macroeconomic Stabilisation

Since Keynes, we have come to a better understanding of the reality that capitalist economies are not necessarily self-stabilising. Keynes and his followers worried about shortfalls in aggregate demand and the resulting unemployment. More recent views of macroeconomic instability stress the inherent instability of financial markets and its transmission to the real economy. All advanced economies have come to acquire fiscal and monetary institutions that perform stabilising functions, having learned the hard way about the consequences of not having them. Probably most important among these institutions is a lender of last resort – typically the central bank – which guards against self-fulfilling banking crises.

There is a strong current within macroeconomic thought – represented in its theoretically most sophisticated version by the real business cycles (RBC) approach – that disputes the possibility or effectiveness of stabilising the macroeconomy through monetary and fiscal policies. There is also a sense in policy circles, particularly in Latin America, that fiscal and monetary institutions – as currently configured – have added to macroeconomic instability, rather than reduced it, by following pro-cyclical rather than anti-cyclical policies (Hausmann and Gavin, 1996). These developments have spurred the trend towards central bank independence, and helped open a new debate on designing more robust fiscal institutions.

Some countries (Argentina being the most significant example) have given up on a domestic lender of last resort altogether by replacing their central bank with a currency board. The Argentine calculation is that having a central bank that can *occasionally* stabilise the economy is not

worth running the risk that the central bank will *mostly* destabilise it. Argentine history gives plenty of reason to think that this is not a bad bet. But can the same be said for Mexico or Brazil, or, for that matter, Turkey or Indonesia? What may work for Argentina may not work for the others. The debate over currency boards and dollarisation illustrates the obvious, but occasionally neglected, fact that the institutions needed by a country are not independent of that country's history.

Institutions for Social Insurance

A modern market economy is one in which change is constant, and idiosyncratic (i.e., individual-specific) risk to incomes and employment is pervasive. Modern economic growth entails a transition from a static economy to a dynamic one in which the tasks that workers perform are in constant evolution, and movement up and down the income scale is frequent. One of the liberating effects of a dynamic market economy is that it frees individuals from their traditional entanglements – the kin group, the church, the village hierarchy. The flip side is that it uproots them from traditional support systems and risk-sharing institutions. Gift exchanges, the fiesta, and kinship ties – to cite just a few of the social arrangements for equalising the distribution of resources in traditional societies – lose much of their social insurance functions. And the risks that have to be insured against become much less manageable in the traditional manner as markets spread.

The huge expansion of publicly provided social insurance programmes during the twentieth century is one of the most remarkable features of the evolution of advanced market economies. In the United States, it was the trauma of the Great Depression that paved the way for the major institutional innovations in this area: Social Security, unemployment compensation, public works, public ownership, deposit insurance, and legislation favouring unions (see Bordo et al., 1998: 6). As Jacoby (1998) notes, prior to the Great Depression the middle classes were generally able to self-insure or buy insurance from private intermediaries. As these private forms of insurance collapsed, the middle classes threw their considerable political weight behind the extension of social insurance and the creation of what would later be called the welfare state. In Europe, the roots of the welfare state reached in some cases to the tail end of the nineteenth century. But the striking expansion of social insurance programmes, particularly in the smaller economies most open to foreign trade, was a post-World War II phenomenon (Rodrik, 1998). Despite a considerable political backlash against the welfare state since the 1980s, neither the US nor Europe has significantly scaled back these programmes.

Social insurance need not always take the form of transfer programmes paid out of fiscal resources. The East Asian model, represented well by the Japanese case, is one in which social insurance is provided through a combination of enterprise practices (such as lifetime employment and enterprise-provided social benefits), sheltered and regulated sectors (mom-and-pop stores), and an incremental approach to liberalisation and external opening. Certain aspects of Japanese society that seem inefficient to outside observers – such as the preference for small-scale retail stores or extensive regulation of product markets – can be viewed as substitutes for the transfer programmes that would otherwise have to be provided (as it is in most European nations) by a welfare state. Such complementarities among different institutional arrangements within a society have the important implication that it is very difficult to alter national systems in a piecemeal fashion. One cannot (or should not) ask the Japanese to get rid of their lifetime employment practices or inefficient retail arrangements without ensuring that alternative safety nets are in place. Another implication is that substantial institutional changes come only in the aftermath of large dislocations, such as those created by the Great Depression or World War II.

Social insurance legitimises a market economy because it renders it compatible with social stability and social cohesion. At the same time, the existing welfare states in Western Europe and the United States engender a number of economic and social costs – mounting fiscal outlays, an 'entitlement' culture, and long-term unemployment – which have become increasingly apparent. Partly because of that, developing countries, such as those in Latin America that adopted the market-oriented model following the debt crisis of the 1980s, have not paid sufficient attention to creating institutions of social insurance (Rodrik, 1999d). The upshot has been economic insecurity and a backlash against the reforms. How these countries will maintain social cohesion in the face of large inequalities and volatile outcomes, both of which are being aggravated by the growing reliance on market forces, is a question without an obvious answer at the moment. But if Latin America and the other developing regions are to carve a different path in social insurance than that followed by Europe or North America, they will have to develop their own vision – and their own institutional innovations – to bridge the tension between market forces and the yearning for economic security.

Institutions of Conflict Management

Societies differ in their cleavages. Some are made up of an ethnically and linguistically homogeneous population marked by a relatively egalitarian distribution of resources (Finland?). Others are characterised by deep

cleavages along ethnic or income lines (Nigeria?). These divisions, when not bridged adequately, can hamper social cooperation and prevent the undertaking of mutually beneficial projects. Social conflict is harmful both because it diverts resources form economically productive activities and because it discourages such activities by the uncertainty it generates. Economists have used models of social conflict to shed light on questions such as: why do governments delay stabilisations when delay imposes costs on all groups? (Alesina and Drazen, 1991); why do countries rich in natural resources often do worse than countries that are resource-poor? (Tornell and Lane, 1999); why do external shocks often lead to protracted economic crises that are out of proportion to the direct costs of the shocks themselves? (Rodrik, 1999c).

All of these can be thought of as instances of coordination failure in which social factions fail to coordinate on outcomes that would be of mutual benefit. Healthy societies have a range of institutions that make such colossal coordination failures less likely. The rule of law, a high-quality judiciary, representative political institutions, free elections, independent trade unions, social partnerships, institutionalised representation of minority groups, and social insurance are examples of such institutions. What makes these arrangements function as institutions of conflict management is that they entail a double 'commitment technology': they warn the potential 'winners' of social conflict that their gains will be limited, and assure the 'losers' that they will not be expropriated. They tend to increase the incentives for social groups to cooperate by reducing the payoff to socially uncooperative strategies.

HOW ARE 'GOOD' INSTITUTIONS ACQUIRED?

As I argued in the preceding section, a market economy relies on a wide array of non-market institutions that perform regulatory, stabilising, and legitimising functions. Once these institutions are accepted as part and parcel of a market-based economy, traditional dichotomies between market and state or laissez-faire and intervention begin to make less sense. These are not competing ways of organising a society's economic affairs; they are complementary elements that render the system sustainable. Every well-functioning market economy is a mix of state and market, laissez faire and intervention.

Accepting Institutional Diversity

A second major implication of the discussion is that the institutional basis for a market economy is not uniquely determined.[6] Formally, there is no

single mapping between the market and the set of non-market institutions required to sustain it. This finds reflection in the wide variety of regulatory, stabilising, and legitimising institutions that we observe in today's advanced industrial societies. The American style of capitalism is very different from the Japanese style of capitalism. Both differ from the European style. And even within Europe, there are large differences between the institutional arrangements in, say, Sweden and Germany. Few would disagree about the existence of such differences. Yet much of institutional reform in developing countries is predicated on the assumption that there is a single set of institutions worth emulating.

The view that one set of institutional arrangements necessarily dominates others in terms of overall performance is a common journalistic error. Hence the fads of the decade: with its low unemployment, high growth, and thriving culture, Europe was the continent to emulate throughout much of the 1970s; during the trade-conscious 1980s, Japan became the exemplar of choice; and the 1990s have been the decade of US-style freewheeling capitalism. It is anybody's guess which set of countries will capture the imagination if and when a substantial correction hits the US stock market.[7]

The point about institutional diversity has in fact a more fundamental implication. The institutional arrangements that we observe in operation today, varied as they are, themselves constitute a *subset* of the full range of potential institutional possibilities. This is a point that has been forcefully and usefully argued by Roberto Unger (1998). There is no reason to suppose that modern societies have already managed to exhaust all the useful institutional variations that could underpin healthy and vibrant economies. Even if we accept that market-based economies require certain types of institutions, as listed in the previous section,

> such imperatives do not select from a closed list of institutional possibilities. The possibilities do not come in the form of indivisible systems, standing or falling together. There are always alternative sets of arrangements capable of meeting the same practical tests. (Unger 1998: 24–5)

We need to maintain a healthy scepticism towards the idea that a specific type of institution – a particular mode of corporate governance, social security system, or labour market legislation, for example – is the only type that is compatible with a well-functioning market economy.

Two Modes of Acquiring Institutions

How does a developing society acquire functional institutions – functional in the sense of supporting a healthy, sustainable market-based system? An

analogy with *technology transfer* is helpful. Think of institution acquisition/building as the adoption of a new technology that allows society to transform its primary endowments (land, raw labour, natural resources) into a larger bundle of outputs. Let us call this new technology a 'market economy', where we understand that the term encompasses all of the non-market institutional complements discussed previously. Adoption of a market economy in this broad sense moves society to a higher production possibilities frontier, and in that sense is equivalent to technical progress in economists' parlance.

But what kind of a technology is a market economy? To oversimplify, consider two possibilities. One possibility is that the new technology is a general purpose one, that it is codified, and that it is readily available on world markets. In this case, it can be adopted by simply importing a *blueprint* from the more advanced economies. The transition to a market economy, in this vision, consists of getting a manual with the title 'how to build a market economy' (a.k.a. the 'Washington Consensus') and following the directions: remove price distortions, privatise enterprises, harden budget constraints, enact legal codes, and so on.

A different possibility is that the requisite technology is highly specific to local conditions and that it contains a high degree of tacitness. Specificity implies that the institutional repertoire available in the advanced countries may be inappropriate to the needs of the society in question – just as different relative factor prices in LDC agriculture require more appropriate techniques than those that are available in the rich countries. Tacitness implies that much of the knowledge that is required is in fact not written down, leaving the blueprints highly incomplete.[8] For both sets of reasons, imported blueprints are useless. Institutions need to be developed locally, relying on hands-on experience, local knowledge, and experimentation.

The two scenarios are of course only caricatures. Neither the *blueprint* nor the *local-knowledge* perspective captures the whole story on its own. Even under the best possible circumstances, an imported blueprint requires domestic expertise for successful implementation. Alternatively, when local conditions differ greatly, it would be unwise to deny the possible relevance of institutional examples from elsewhere. But the dichotomy – whether one emphasises the blueprint or the local knowledge aspect of the process – clarifies some key issues in institution building and sheds light on important debates about institutional development. Consider the debate on Chinese gradualism.

One perspective, represented forcefully in work by Sachs and Woo (forthcoming), underplays the relevance of Chinese particularism by arguing that the successes of the economy are not due to any special aspects of the Chinese transition to a market economy but instead are largely due to a

convergence of Chinese institutions to those in non-socialist economies. In this view, the faster the convergence, the better the outcomes. '[F]avourable outcomes have emerged not because of gradualism, but despite gradualism' (Sachs and Woo, forthcoming: 3). The policy message that follows is that China should focus not on institutional experimentation but on harmonising its institutions with those abroad. (To be fair to these authors, the harmonisation that Sachs and Woo foresee seems to be with the institutions in the rest of East Asia, not those of the US or Western Europe.)

The alternative perspective, perhaps best developed in work by Qian and Roland, is that the peculiarities of the Chinese model represent solutions to particular political or informational problems for which no blueprint-style solution exists. Hence Lau, Qian, and Roland (1997) interpret the dual-track approach to liberalisation as a way of implementing Pareto-efficient reforms: an alteration in the planned economy that improves incentives at the margin, enhances efficiency in resource allocation, and yet leaves none of the plan beneficiaries worse off. Qian, Roland and Xu (1999) interpret Chinese-style decentralisation as allowing the development of superior institutions of coordination: when economic activity requires products with matched attributes,[9] local experimentation is a more effective way of processing and using local knowledge.

Sachs, Woo, and other members of the convergence school worry about the costs of Chinese-style experimentalism because they seem to say, 'Well, we already know what a market economy looks like: it is one with private property and a unified system of prices – just get on with it.' Qian et al. on the other hand, find much to praise in it because they think the system generates the right incentives for developing the tacit knowledge required to build and sustain a market economy, and therefore they choose not to be bothered by some of the economic inefficiencies that may be generated along the way. These two contrasting visions of where the real action is in the transition to a market economy have been pervasive in our discussions of policy and have played a determining role in shaping our preferences for gradualism/experimentalism versus shock therapy.

Although my sympathies in this debate are with the experimentalists, I can also see that there are dangers with experimentalism. First, one needs to be clear between self-conscious experimentalism, on the one hand, and delay and gradualism designed primarily to serve privileged interests, on the other. The dithering, two-steps-forwards, one-step-backwards style of reform that prevails in much of the former Soviet Union and in many sub-Saharan African countries is driven not so much by a desire to build better institutions as it is by aversion to reform. This has to be distinguished from a programmatic effort to acquire and process local knowledge to better serve local needs. The gradualism that countries like Mauritius[10] or South

Korea[11] have exhibited over their recent history is very different than the 'gradualism' of Ukraine or Nigeria.

Second, it is obviously costly – in terms of time and resources – to build institutions from scratch when imported blueprints can serve just as well. Costs in this context have to be evaluated carefully, since forgoing experimentalism can have opportunity costs as well insofar as it forecloses certain paths of *future* institutional development. Nonetheless, experimentalism can backfire if it overlooks opportunities for institutional arbitrage. Much of the legislation establishing an SEC-like watchdog agency for securities markets, for example, can be borrowed wholesale from those countries that have already learned how to regulate these markets the hard way – by their own trial and error. The same goes perhaps for an anti-trust agency, a financial supervisory agency, a central bank, and many other governmental functions. One can always learn from the institutional arrangements prevailing elsewhere even if they are inappropriate or cannot be transplanted. Some societies can go further by adopting institutions that cut deeper – in social insurance, labour markets, fiscal institutions. Perhaps one reason that a 'big bang' worked for Poland is that this country had already defined its future: it wanted to be a 'normal' European society, with full membership in the European Union. Adopting European institutions wholesale was not only a means to an end; it was also the ultimate objective the country desired.

The difficult questions, and the trade-offs between the blueprint and the experimentalist approaches, arise when the attainable objectives are not so clear-cut. What kind of a society do the Chinese want for themselves, and can realistically hope to achieve? How about the Brazilians, Indians, or Turks? Local knowledge matters greatly in answering these questions. Blueprints, best practices, international codes and standards, harmonisation can do the trick for some of the narrowly 'technical' issues. But large-scale institutional development by and large requires a process of discovery about local needs and capabilities.

Participatory Politics as a Meta-institution

The blueprint approach is largely top-down, relying on expertise on the part of technocrats and foreign advisors. The local-knowledge approach, by contrast, is bottom-up and relies on mechanisms for eliciting and aggregating local information. In principle, these mechanisms can be as diverse as the institutions that they help create. But I would argue that the most reliable forms of such mechanisms are participatory political institutions. Indeed, it is helpful to think of participatory political institutions as *meta-institutions* that elicit and aggregate local knowledge and thereby help build better institutions.

It is certainly true that non-democratic forms of government have often succeeded admirably in the task of institution building using alternative devices. The previously mentioned examples of South Korea (with its 'embedded' bureaucratic autonomy) and China (with its decentralisation and experimentalism) come immediately to mind. But the broad, cross-national evidence indicates that these are the exceptions rather than the rule. Nothing prevents authoritarian regimes from using local knowledge; the trouble is that nothing compels them to do so either.

The case of Mauritius illustrates nicely how participatory democracy helps build better institutions that lay the foundation for sustainable economic growth. The initial conditions in Mauritius were inauspicious from a number of standpoints. The island was a monocrop economy in the early 1960s and faced a population explosion. A report prepared by James Meade in 1961 was quite pessimistic about the island's future, and argued that 'unless resolute measures are taken to solve [the population problem], Mauritius will be faced with a catastrophic situation' (Meade, 1961: 37). Mauritius is also an ethnically and linguistically divided society and its independence in 1968 was preceded by a series of riots between Muslims and Creoles.

Mauritius's superior economic performance has been built on a peculiar combination of orthodox and heterodox strategies. To an important extent, the economy's success was based on the creation of an export processing zone (EPZ) operating under free-trade principles, which enabled an export boom in garments to European markets and an accompanying investment boom at home. Yet the island's economy has combined the EPZ with a domestic sector that was highly protected until the mid-1980s.[12] Mauritius is essentially an example of an economy that has followed a two-track strategy not too dissimilar to that of China. This economic strategy was in turn underpinned by social and political arrangements that encouraged participation, representation, and coalition-building. Rather than discouraging social organisation, governments have encouraged it. In the words of Miles (1999), Mauritius is a 'supercivil society', with a disproportionately large number of civil society associations per capita.

The circumstances under which the Mauritian EPZ was set up in 1970 are instructive, and highlight the manner in which participatory political systems help design creative strategies for building locally adapted institutions. Given the small size of the home market, it was evident that Mauritius would benefit from an outward-oriented strategy. But as in other developing countries, policymakers had to contend with the import-substituting industrialists who had been propped up by the restrictive commercial policies of the early 1960s prior to independence. These industrialists were naturally opposed to relaxing the trade regime.

A Washington economist would have advocated across-the-board liberalisation, without regard to what that might do to the precarious political and social balance of the island. Instead, the Mauritian authorities chose the two-track strategy. The EPZ scheme in fact provided a neat way around the political difficulties. The creation of the EPZ generated new opportunities of trade and of employment, without taking protection away from the import-substituting groups and from the male workers who dominated the established industries. The segmentation of labour markets early on between male and female workers – with the latter predominantly employed in the EPZ – was particularly crucial, as it prevented the expansion of the EPZ from driving wages up in the rest of the economy, thereby disadvantaging import-substituting industries. New profit opportunities were created at the margin, while leaving old opportunities undisturbed. There were no identifiable losers. This in turn paved the way for the more substantial liberalisations that took place in the mid-1980s and in the 1990s.

Mauritius found its own way to economic development because it created social and political institutions that encouraged participation, negotiation, and compromise. That it did so despite inauspicious beginnings and following a path that diverged from orthodoxy speaks volumes about the importance of such institutions. The following section presents some cross-national evidence suggesting that democracy tends in fact to be a reliable mechanism for generating such desirable outcomes.

PARTICIPATORY POLITICAL REGIMES DELIVER HIGHER-QUALITY GROWTH

In policy circles, the discussion on the relationship between political regime type and economic performance inevitably gravitates toward the experience of a handful of economies in East and Southeast Asia, which (until recently at least) registered the world's highest growth rates under authoritarian regimes. These countries constitute the chief exhibit for the argument that economic development requires a strong hand from above. The deep economic reforms needed to embark on self-sustaining growth, this line of thought goes, cannot be undertaken in the messy push and pull of democratic politics. Chile under General Pinochet is usually exhibit no. 2.

A systematic look at the evidence, however, yields a much more sanguine conclusion. While East Asian countries have prospered under authoritarianism, many more have seen their economies deteriorate – think of Zaire, Uganda or Haiti. Recent empirical studies based on samples of more than 100 countries suggest that there is little reason to believe democracy is conducive to lower growth over long time spans.[13] Neither is it the case that

economic reforms are typically associated with authoritarian regimes (Williamson, 1994). Indeed, some of the most successful reforms of the 1980s and 1990s were implemented under newly elected democratic governments – think of the stabilisations in Bolivia (1985), Argentina (1991) and Brazil (1994), for example. Among former socialist economies too, the most successful transitions have occurred in the most democratic countries.

In fact, the record is even more favourable to participatory regimes than is usually acknowledged. This section provides evidence in support of the following assertions:[14]

1. Democracies yield long-run growth rates that are more predictable.
2. Democracies produce greater short-term stability.
3. Democracies handle adverse shocks much better.
4. Democracies deliver better distributional outcomes.

The first of these implies that economic life is less of a crapshoot under democracy. The second suggests that, whatever the long-run growth level of an economy, there is less instability in economic outcomes under democratic regimes than under autocracies. The third finding indicates that political participation improves an economy's capacity to adjust to changes in the external environment. The final point suggests that democracies produce superior distributional outcomes.

Taken together these results provide a clear message: participatory political regimes deliver higher-quality growth. I would contend that they do so because they produce superior institutions better suited to local conditions.

Democracy and Long-term Performance

Figure 2.1 shows a scatter plot for a sample of 90 countries. The figure shows the *partial* relationship between a country's level of democracy and its growth rate of GDP per capita during the 1970–89 period, after initial income, education, and regional effects are controlled for. Democracy is measured on a scale of 0 to 1, using the Freedom House index of political rights and civil liberties. While the slope of the relationship is positive and statistically significant, this result is not very robust. As is clear from the figure, removing Botswana – which is an important outlier – would make a big difference to the results. This is in line with existing results in the literature, which suggest that there is no strong, determinate relationship between political participation and average levels of long-run growth.

Looking at individual cases, it becomes quickly evident why this is so. Among high-growth countries, Taiwan, Singapore and Korea rank low in terms of democracy (during the period covered by the regression), this

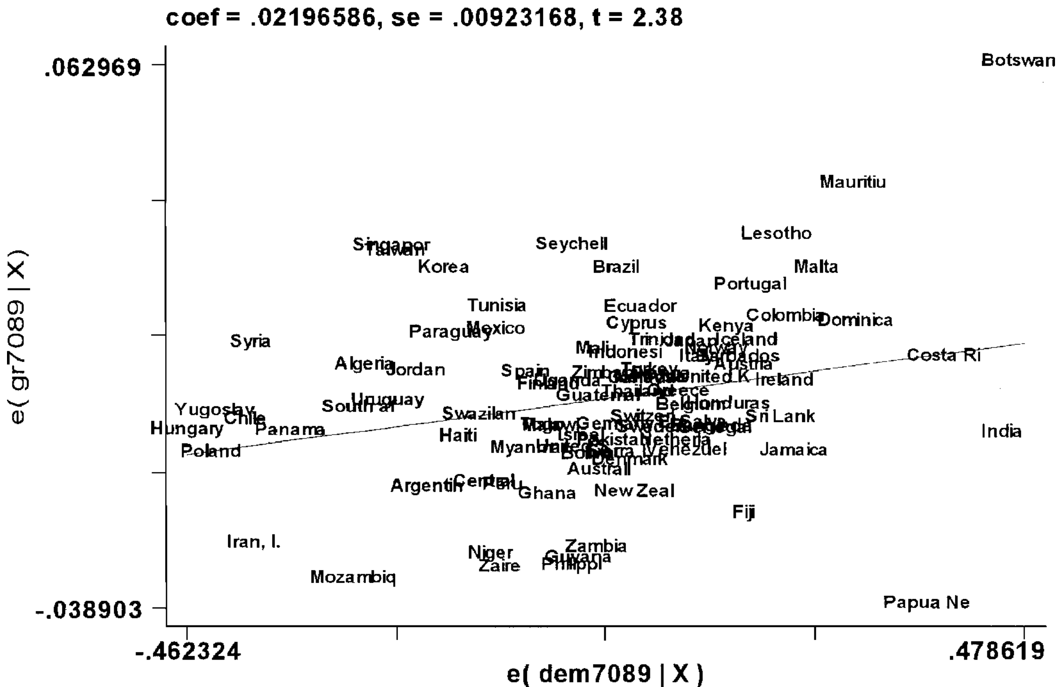


Figure 2.1 *Partial correlation between democracy and economic growth, 1970–89 (controlling for initial income, education, and regional dummies)*

being the source of the conventional wisdom among policymakers reported above. But some other countries, Botswana and Mauritius in particular, have done equally well or even better under fairly open political regimes. (Note that the rankings in this figure have to be interpreted relative to the benchmarks established by the presence of the other controls in the regression.) Poor performers can similarly be found at either end of the democracy spectrum: South Africa and Mozambique have done poorly under authoritarian regimes, Papua New Guinea and Jamaica under relatively democratic ones.

Hence *mean* long-run growth rates tend not to depend systematically on political regime type. But this is only part of the broader picture. A different question is whether democracy is the safer choice in the following sense: is the cross-national *variance* in long-run growth performance smaller under democracies than it is under autocracies? Since mean growth rates do not differ, a risk-averse individual would unambiguously prefer to live under the regime where expected long-run growth rates cluster more closely around the mean.

I first divide the country sample into two roughly equal-sized groups. I call those with values of the democracy index less than 0.5 'autocracies' (n = 48), and those with values greater or equal to 0.5 'democracies' (n = 45). The top panel in Table 2.1 shows the coefficients of variation of long-run growth rates, computed across countries for the 1960–89 period, for the two samples. The first row shows the unconditional coefficients of variation, without any controls for determinants of growth rates. The second row displays the conditional version of the same, where the variation now refers to the unexplained component from a cross-national regression (separate for each sample) with the following control variables:

Table 2.1 Variance of economic performance under different political regimes

	coeff. of variation of long-run economic growth rates under:	
	autocracies	democracies
unconditional	1.05	0.54
conditional	0.70	0.48
	'low democracy'	'high democracy'
unconditional	1.02	0.61
conditional	0.64	0.54

Note: See text for explanation.

initial GDP per capita, initial secondary school enrolment ratio, and regional dummies for Latin America, East Asia, and sub-Saharan Africa. I find that the coefficient of variation (whether conditional or unconditional) is substantially higher for autocracies than it is for democracies.

Since countries with authoritarian regimes tend to have lower incomes, perhaps this result reflects the greater randomness in the long-run growth rates of poor countries. To check against this possibility, I divided countries differently. First, I regressed the democracy index on income and secondary enrolment levels across countries ($R^2 = 0.57$). Then I regrouped my sample of countries according to whether their actual democracy levels stood below or above the regression line. Countries above (below) the regression line are those with greater (less) political participation than would be expected on the basis of their income and educational levels. In the bottom panel of Table 2.1, these two groups are labelled 'high democracy' (n = 49) and 'low democracy' (n = 44) respectively. The coefficients of variation for long-term growth rates are then calculated for each group in the same way as before. Our results remain qualitatively unchanged, although the gap between the two groups shrinks somewhat: the coefficient of variation is smaller in countries with greater political participation (where 'greater' now refers to the benchmark set by the cross-national regression relating participation levels to income and education).

The bottom line is that living under an authoritarian regime is a riskier gamble than living under a democracy.

Democracy and Short-term Performance

A point similar, but not identical, to the one just discussed was anticipated by Sah (1991), who argued that decentralised political regimes (and democracies in particular) should be less prone to volatility. The rationale behind this idea is that the presence of a wider range of decisionmakers results in greater diversification and hence less risk in an environment rife with imperfect information. This is a point similar to the one made above regarding the importance of local knowledge. Note that this specific argument is about short-term volatility in economic performance, and not about the dispersion in long-term growth rates that was the focus of the previous section.

To determine the relationship between regime type and volatility in short-run economic performance, I focus on three national-accounts aggregates: (a) real GDP; (b) real consumption; and (c) investment. (All data are from the Penn World Tables, Mark 5.6.) In each case, volatility is measured by calculating the standard deviation of annual growth rates of the relevant aggregate over the 1960–89 period (more accurately, by taking

Table 2.2 Political participation and volatility of economic performance

(estimated coefficient on democracy from multiple regression)				
	dependent variable			
	standard deviation of growth rate of:			
	real GDP OLS	consumption OLS	investment OLS	consumption IV
democracy	−1.31**	−2.33**	−4.36*	−4.97**
	(0.60)	(1.09)	(1.61)	(2.10)
N	101	101	101	88

Note: Additional regressors (not shown): log per-capita GDP, log population, a measure of exposure to external risk, dummies for Latin America, East Asia, sub-Saharan Africa, and OECD. Robust standard errors reported in parentheses. Secondary enrolment ratio used as instrument in IV estimation. Asterisks denote levels of statistical significance: *99 per cent; **95 per cent.

the standard deviation of the first differences in logs). Then each measure of volatility is regressed on a number of independent variables, including our measure of participation (democracy). The other independent variables included are: log per-capita GDP, log population, exposure to external risk, and dummies for Latin America, East Asia, sub-Saharan Africa and OECD.

Table 2.2 shows the results. The estimated coefficient on the measure of democracy is negative and statistically significant in all cases. A movement from pure autocracy (democracy = 0) to pure democracy (= 1) is associated with reductions in the standard deviations of growth rates of GDP, consumption, and investment of 1.3, 2.3, and 4.4 percentage points, respectively. These effects are fairly sizeable. Figure 2.2 shows a partial scatter plot which helps identify where different countries stand. Long-standing democracies such as India, Costa Rica, Malta and Mauritius have experienced significantly less volatility than countries like Syria, Chile, or Iran, even after controlling for country size and external shocks.[15]

Moreover, as the last column of Table 2.2 shows, causality seems to run directly from regime type to volatility (rather than vice versa). In this column I have used secondary enrolment ratio as an instrument for democracy (in addition to the other independent variables mentioned earlier). This variable has all the properties of a desirable instrument, as it is well correlated with democracy but virtually uncorrelated with the error term from the OLS regression. With democracy instrumented in this fashion, the estimated coefficient actually *doubles* in absolute value.

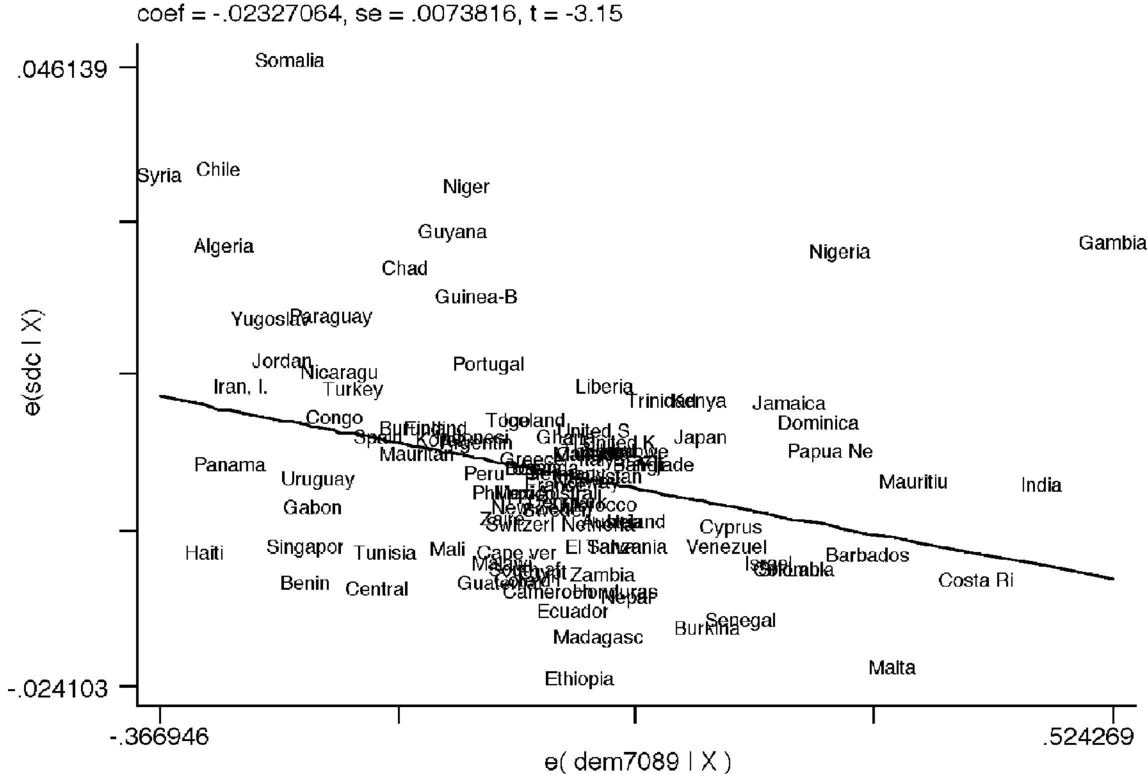


Figure 2.2 Partial correlation between democracy and consumption volatility

The evidence strongly suggests, therefore, that democracy is conducive to lower volatility in economic performance.

Democracy and Resilience in the Face of Economic Shocks

The late 1970s were a watershed for most developing economies. A succession of external shocks during this period left many of them in severe payment difficulties. In some cases, as in most of Latin America, it took almost a decade for macroeconomic balances to be restored and for growth to resume. The question I now pose is whether democratic and participatory institutions helped or hindered adjustment to these shocks of external origin.

The main thing I am interested in explaining is the extent of economic collapse following an external shock. In another paper (Rodrik, 1999c), I have explored how social cleavages and domestic institutions of conflict management mediate the effects of shocks on economic performance. Here I focus on the role of participatory institutions specifically.

In a recent review of the growth experience of developing countries, Pritchett (1997) has looked for breaks in trend growth rates. These breaks tend to coalesce around the mid- to late 1970s, with 1977 as the median break year. I use the difference in growth rates before and after the break as my dependent variable.

The basic story in Rodrik (1999c) is that the adjustment to shocks will tend to be worse in countries with deep latent social conflicts and with poor institutions of conflict management. Consequently, such countries will experience larger declines in growth rates following shocks. These ideas are tested by regressing the *change* in growth on indicators of latent conflict and on proxies for institutions of conflict management (in addition to other variables[16]). Figure 2.3 displays a sample partial scatter plot, showing the relationship between ethnic cleavages and the growth decline. Controlling for other variables, there is a systematic relationship between these two: countries with greater ethnic and linguistic fragmentation experienced larger declines in economic growth.[17]

Our interest in democratic institutions in this context derives from the idea that such institutions provide ways of regulating and managing social conflicts through participatory means and the rule of law, and hence dissipate the adverse consequences of external shocks. To test this hypothesis, we check to see whether our measure of democracy – this time restricted to the 1970s only, to avoid possible reverse-causality – is related to changes in growth rates subsequent to the shocks. The partial scatter plot shown in Figure 2.4, covering 101 countries, suggests a clear affirmative answer. Countries with greater political freedoms during the 1970s experienced

coef = -1.8392835, se = .83629833, t = -2.2

e(differen | X)

4.30598

-5.65361

-.557479

.553313

e(elf60 | X)

Figure 2.3   Ethnic cleavages and growth differentials (pre- and post-break year in trend growth)

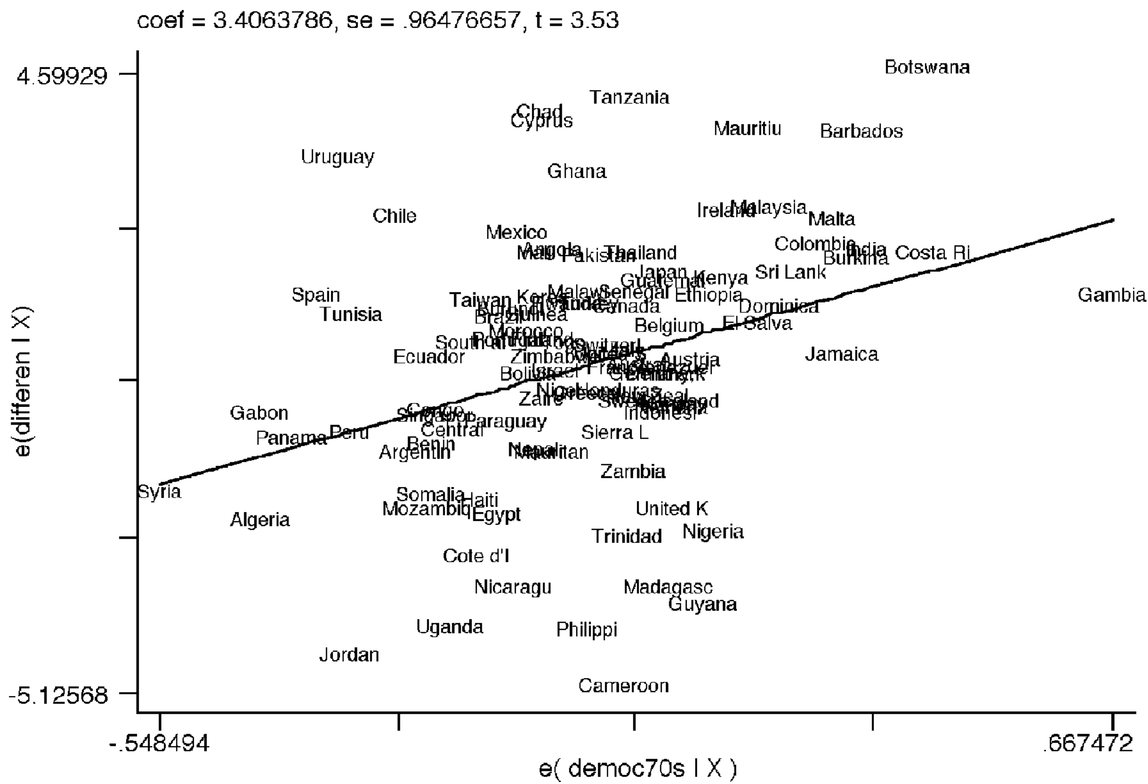


Figure 2.4 Democracy and growth differentials (pre- and post-break year in trend growth)

lower declines in economic growth when their trend growth rate changed. The relationship is highly significant in statistical terms; the t-statistic on the estimated coefficient on democracy is 3.53, with a p-value of 0.001. Figure 2.5 shows the results when sub-Saharan African countries are excluded from the sample. The reason to exclude these is both concern with data quality and the possibility that the relationship is driven by a few African countries with extreme values. But the relationship holds just as well in the restricted sample: the partial slope coefficient is virtually unchanged and the t-statistic is almost as high (3.32). As these two figures show, the hardest hit countries tended to be those with few political liberties (relative to what would be expected of countries at their levels of income), such as Syria, Algeria, Panama and Gabon. Countries with open political regimes, such as Costa Rica, Botswana, Barbados and India did much better.

These results are perhaps surprising in view of the common presumption that it takes strong, autonomous governments to undertake the policy adjustments required in the face of adversity. They are less surprising from the perspective articulated above: adjustment to shocks requires managing social conflicts, and democratic institutions are useful institutions of conflict management.

To probe the issues more deeply, I investigate the relationship between declines in growth and three other aspects of political regime: (a) the degree of institutional (*de jure*) independence of the executive; (b) the degree of operational (*de facto*) independence of the executive; and (c) the degree to which non-elites can access political institutions. These three variables come originally from the Polity III data (see Jaggers and Gurr, 1995), and have been recoded on a scale of 0 to 1 for the purposes of the current exercise. As before, I use the averages of the values reported for each country during the 1970s. Note that these three indicators are correlated with the Freedom House measure of democracy (which I have been using up to this point) in the expected manner: independence of the executive tends to be lower in democracies, and avenues of non-elite participation are larger. But there are interesting exceptions. The United States, for example, ranks highest not only on the democracy index, but also in the degree of *institutional* (*de jure*) independence of the executive. Other democracies with relatively autonomous executives (*de jure*) are France, Canada and Costa Rica. By contrast, South Africa is coded as having had (during the 1970s) little democracy *and* little executive autonomy.

A nagging question in the literature on political economy is whether an insulated and autonomous executive is necessary for the implementation of economic reforms.[18] This question is somewhat distinct from the question about democracy proper, since, as the examples just mentioned illustrate,

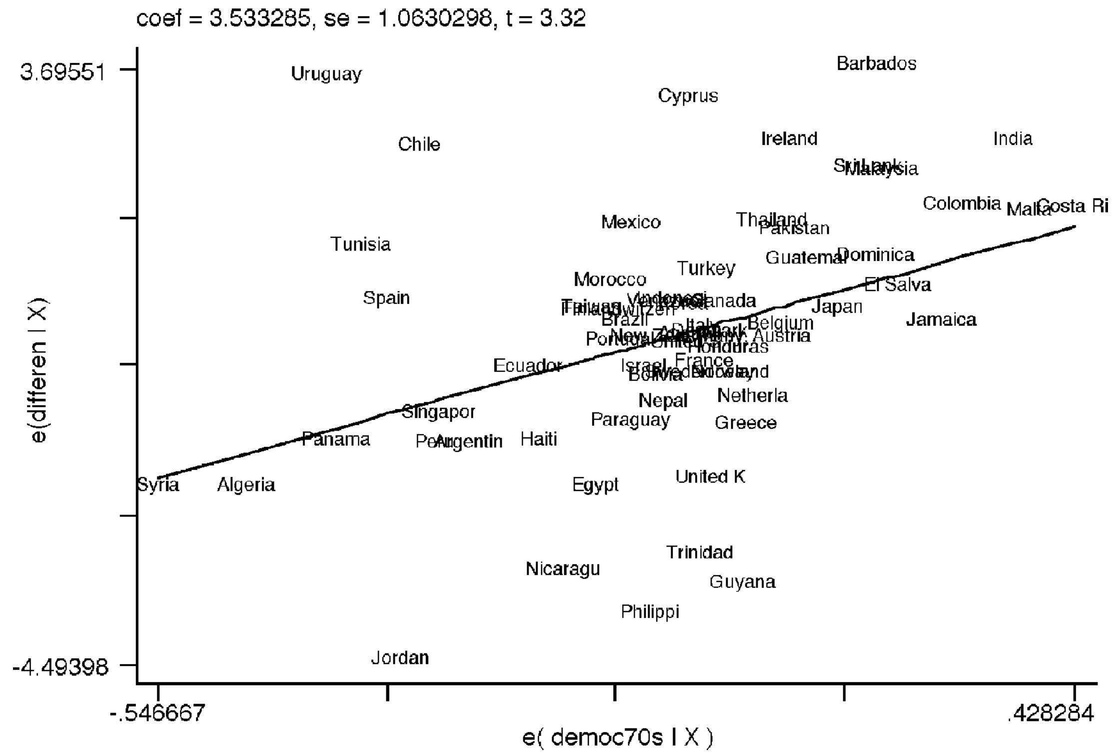


Figure 2.5 *Democracy and growth differentials (pre- and post-break year in trend growth), excluding sub-Saharan African countries*

one can conceive of democratic systems that nonetheless have well-insulated executives. Therefore the Polity III indicators are particularly relevant.

The results shown in Figures 2.6–2.8 are again somewhat surprising – at least when approached from the technocratic perspective. I find that more significant growth declines are associated with *greater* institutional and operational independence of the executive and *lower* levels of political access by non-elites.[19] The estimated coefficients are statistically highly significant in all cases. Therefore, not only do we not find that executive autonomy results in better economic management, the results strongly suggest the converse: political regimes with lower executive autonomy and more participatory institutions handle exogenous shocks better![20] This might be part of the explanation for why democracies experience less economic instability over the long run (as demonstrated in the previous sub-section).

It is worth mentioning in passing that the recent experience in East Asia strongly validates these results. South Korea and Thailand, with more open and participatory political regimes, handled the Asian financial crisis significantly better than Indonesia. I have argued in Rodrik (1999a) that democracy helped the first two countries manage the crisis for at least three reasons. First, it facilitated a smooth transfer of power from a discredited set of politicians to a new group of government leaders. Second, democracy imposed mechanisms of participation, consultation, and bargaining, enabling policymakers to fashion the consensus needed to undertake the necessary policy adjustments decisively. Third, because democracy provides for institutionalised mechanisms of 'voice', the Korean and Thai institutions obviated the need for riots, protests, and other kinds of disruptive actions by affected groups, as well as lowering the support for such behaviour by other groups in society.

Democracy and Distribution

Finally, I turn to distributional issues. I have shown in Rodrik (1999b) that democracy makes an important difference to the distribution of the enterprise surplus in the manufacturing sectors of national economies. In particular, there is a robust and statistically significant association between the extent of political participation and wages received by workers, controlling for labour productivity, income levels, and other possible determinants. The association exists both across countries and over time *within* countries (i.e. in panel regressions with fixed effects as well as in cross-section regressions). Countries with greater political participation than would have been predicted from their income levels, such as India, Israel, Malta and Cyprus, also have correspondingly higher wages relative to productivity. Some countries at the other end of the spectrum – lower-than-expected values for

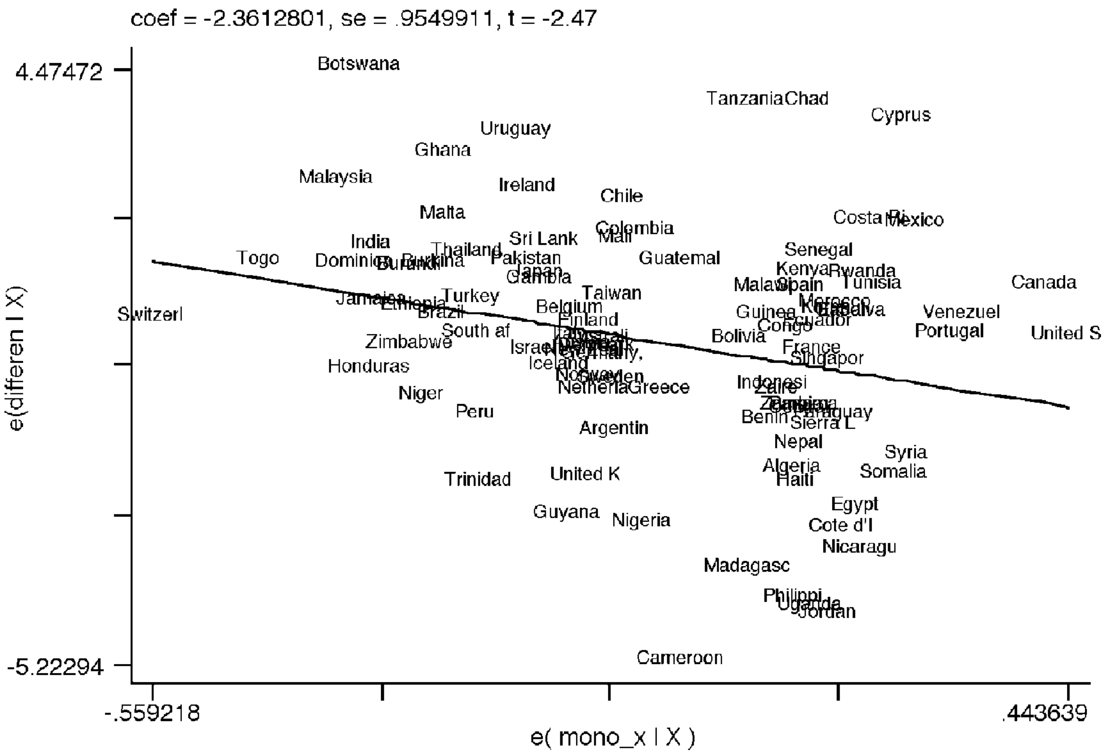


*Figure 2.6 Institutional (*de jure*) independence of the executive and growth differentials (pre- and post-break year in trend growth)*

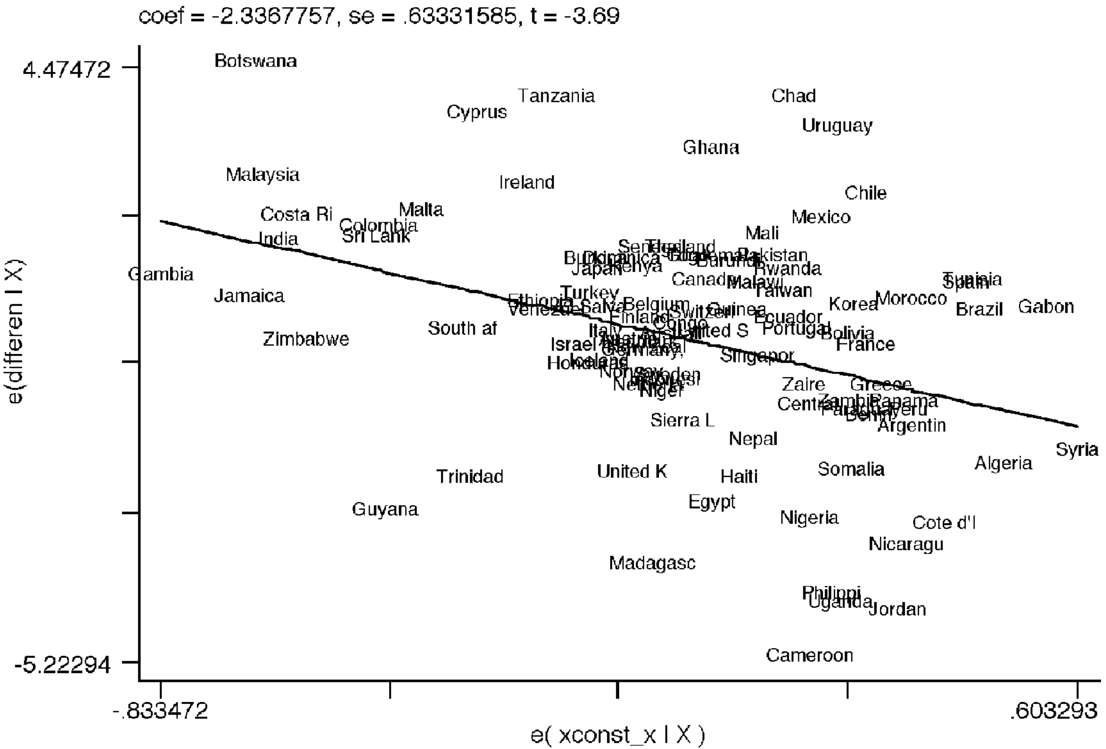


Figure 2.7 *Operational (*de facto*) independence of the executive and growth differentials (pre- and post-break year in trend growth)*

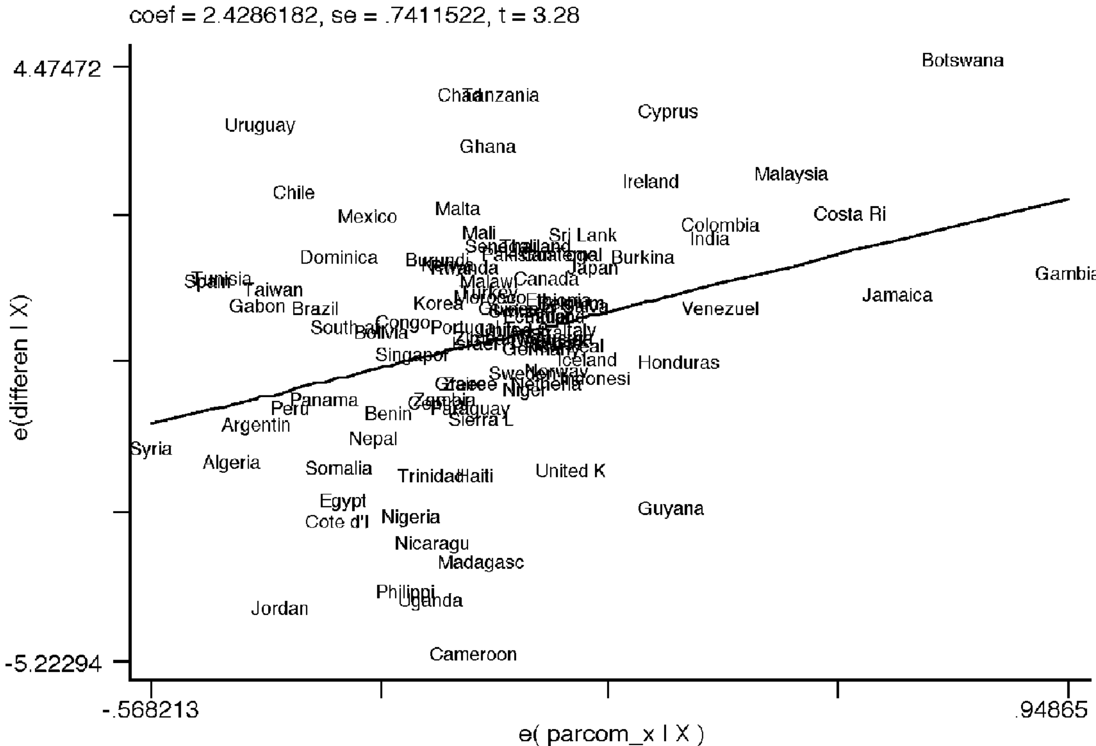


Figure 2.8 *Ability of non-elites to access political institutions and growth differentials (pre- and post-break year in trend growth)*

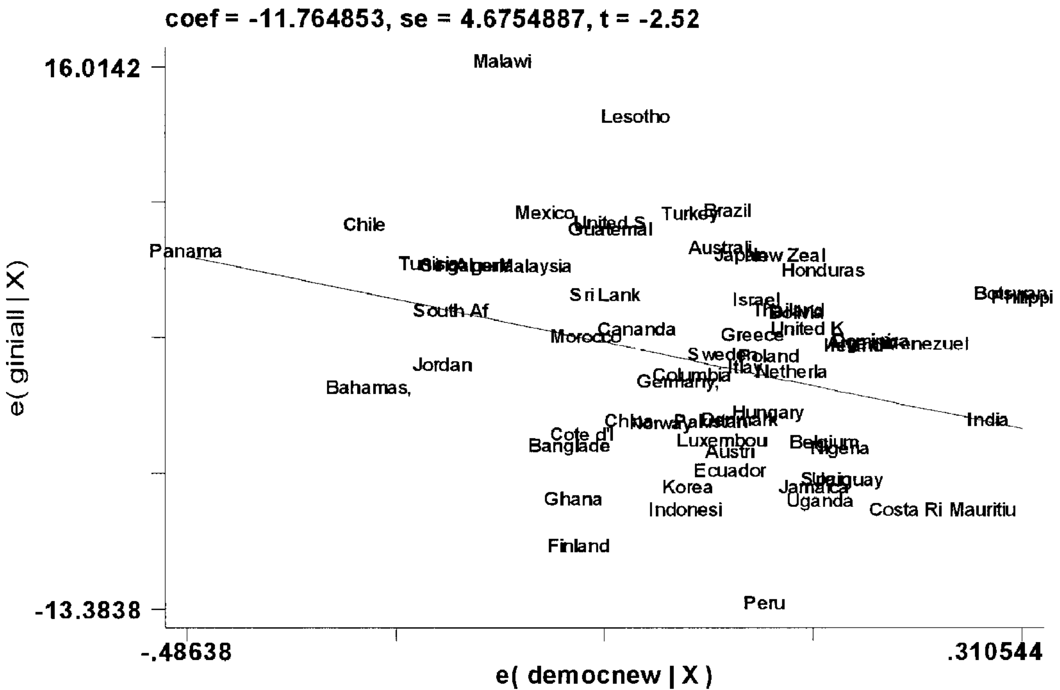
the democracy index and low wages – are Syria, Saudi Arabia, Turkey, and Mexico. Moving from Mexico's level of democracy to that of the US is associated with an increase in wages of about 30 per cent. Instrumental-variables and event-study evidence suggest strongly that the relationship is causal; that is, changes in political regime *cause* a redistribution of the enterprise surplus towards workers.

Figure 2.9 shows a different type of evidence relating to *economy-wide inequality*. One problem with the evidence on the functional distribution of income within manufacturing (discussed above) is that a pro-labour distribution in manufacturing can go hand in hand with a more regressive distribution overall. This would be the case, for example, where pro-labour policies create a 'labour aristocracy' to the detriment of the informal and rural sector worker. Figure 2.9 is quite comforting on that score. It shows that the relationship between democracy and economy-wide inequality (measured by the Gini coefficent from the high-quality Deininger–Squire data set) is in fact negative. More participatory regimes produce greater equality not only within the modern (manufacturing) sector, but throughout the economy. And they do so – as the previous evidence indicates – without cost to economic growth and while producing greater stability and resilience overall.

CONCLUDING REMARKS

Institutional reform has become the buzzword of the day. Policy advisors and international financial institutions (IFIs) find it tempting to extend their advice and conditionality to a broad range of institutional areas, including monetary and fiscal institutions, corporate governance, financial and asset market supervision, labour-market practices, business–government relations, corruption, transparency, and social safety nets. While such efforts have got the basic diagnosis right – the development of a market-based economy requires a heavy dose of institution building – they suffer from two weaknesses.

First, it is not clear whether the IFIs can overcome their bias towards a particular, 'neoliberal' social-economic model – a model that is approximated, if not fully replicated, in the real world by the United States. It is telling that when South Korea recently came under IMF conditionality, the IMF asked the country to undertake an ambitious range of reforms in trade and capital accounts, government–business relations, and labour-market institutions that entailed remoulding the Korean economy in the image of a Washington economist's idea of a free-market economy. This model is not only untested, but it forecloses some development strategies



Note: Controls – log gdp/cap, log gdp/cap squared, urbanisation; dummies for Latin America, East Asia, SSA, socialist countries and oil exporters.

Figure 2.9 Partial association between democracy and economy-wide inequality (Gini coefficient), 1985–89

that have worked in the past, and others that could work in the future. If Korea, a country with an exemplary development record, is subject to pressures of this kind, one can imagine what is in store for small countries with more chequered economic histories. As I have argued in this chapter, an approach that presumes the superiority of a particular model of a capitalist economy is quite restrictive in terms of the range of institutional variation that market economies can (and do) admit.

Second, even if the IFIs could shed their preference in favour of the neoliberal model, there would remain an organisational bias towards providing similar, even if not identical, advice to client governments. It would be difficult for institutions like the World Bank and the IMF to adopt a 'let a hundred flowers bloom' strategy, as it would appear that some countries are being treated more or less favourably. The result is likely to be at best unfriendly to institutional experimentation on the part of client governments.

To be sure, some institutional convergence can be useful and proper. No one can be seriously against the introduction of proper accounting standards or against improved prudential supervision of financial intermediaries. The more serious concern with regard to IFI conditionality is that such standards will act as the wedge with which a broader set of institutional preferences – in favour of open capital accounts, deregulated labour markets, arms-length finance, American-style corporate governance, and hostile to industrial policies – will be imparted on the recipient countries.

My focus on the importance of local knowledge, and on participatory democracy as a meta-institution for eliciting and aggregating it, suggests that conditionality is perhaps better targeted at basic political freedoms. I have shown in this chapter that democracies perform better on a number of dimensions: they produce less randomness and volatility, they are better at managing shocks, and they yield distributional outcomes that are more desirable. One interpretation of these results, and the one that I have emphasised throughout, is that democracy helps build better institutions. While I am a great believer in institutional diversity, I see no argument that would make it appropriate for some governments to deny their citizens basic political rights such as freedom of speech, the right to vote and stand for political office, or freedom of association.

NOTES

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anonymous referee for helpful comments. Reprinted from *Studies in Comparative International Development*, **35** (3), Fall 2000, 3–31. Copyright © 2000 by Transaction Publishers. Reprinted by permission of the publisher.

1. Taken from Miles (1999).
2. See Lin and Nugent (1995) for an excellent review of the huge literature on institutions as it relates to economic development specifically. This literature has been enriched recently by a growing body of empirical cross-national work that quantifies the growth-promoting effects of superior institutions. See Hall and Jones (1999) on 'social infrastructure'; Knack and Keefer (1995, 1996) on bureaucratic quality and social capital; Temple and Johnson (1998) on 'social capability'; Rodrik (1999c) on institutions of conflict management. Recent work by Haufmann, Kraay and Zoido-Lobaton (1999) has developed aggregate indicators of six different aspects of governance – voice and accountability, political instability and violence, government effectiveness, regulatory burden, rule of law, and graft – showing that all of these are significantly associated with income levels in the expected manner.
3. I refer the reader to Unger (1998) for a broader discussion of this point and of its implications. I have benefited greatly from talking with Roberto Unger on some of these issues.
4. See also the recent paper by Johnson and Shleifer (1999) that attributes the more impressive development of equity markets in Poland compared to the Czech Republic to the stronger regulations in the former country upholding minority shareholder rights and guarding against fraud.
5. See Stiglitz and Hoff (1999) for a useful survey and discussion.
6. I am reminded by Ruth Collier that the role of institutional diversity is obvious (or perhaps axiomatic) for many social scientists, even if it is not for economists. What is perhaps surprising in light of that is the 'kind of ideological offensive on the part of certain actors to suggest a single, efficient, successful set of institutions' (Collier, personal correspondence).
7. Perhaps Europe will be back in fashion. As these words were being written, the *New York Times* published a major feature article with the title 'Sweden, the Welfare State, Basks in a New Prosperity' (8 October 1999).
8. An example from South Korea's history with technology acquisition nicely illustrates the tacitness of technology. The Korean shipbuilder Hyundai started out by importing its basic design from a Scottish firm. But it soon found out that this was not working out. The Scottish design relied on building the ship in two halves, because the original manufacturer had enough capacity to build only half a ship at a time. When Hyundai followed the same course, it found out that it could not get the two halves to fit. Subsequent designs imported from European consulting firms also had problems in that the firms would not guarantee the rated capacity, leading to costly delays. In the end, Hyundai was forced to rely on in-house design engineers. This case is discussed in Amsden (1989: 278–89).
9. Think again of the problem of fitting the two halves of a ship described in the previous note.
10. See Wellisz and Saw (1993), Rodrik (1999a, Chap. 3), and the discussion in the next subsection on two-track reforms in Mauritius.
11. South Korea is often portrayed as a case where autonomous and insulated technocrats took a series of decisions without local input. Evans (1995) has usefully emphasised the 'embedded' nature of bureaucratic autonomy in Korea, in particular the dense network of interactions between the bureaucracy and segments of the private sector that allowed for the exchange of information, the negotiation and renegotiation of policies, and the setting of priorities.
12. Gulhati (1990: Table 2.10) reports an average effective rate of protection in 1982 for manufacturing in Mauritius of 89%, with a range of −4% to 824%.
13. Helliwell (1994) and Barro (1996) try to control for the endogeneity of democracy in estimating the effect of the latter on growth. Helliwell finds that democracy spurs education and investment, but has a negative (and insignificant) effect on growth when investment

and education are controlled. On balance, he finds no 'systematic net effects of democracy on subsequent economic growth'. Barro finds a non-linear relationship, with growth increasing in democracy at low levels of democracy and decreasing in democracy at higher levels. The turning point comes roughly at the levels of democracy existing in Malaysia and Mexico (in 1994), and somewhat above South Africa's level prior to its transition. A more recent paper by Chowdhurie-Aziz (1997) finds a positive association between the degree of non-elite participation in politics and economic growth. See also Tavares and Wacziarg (1996) who estimate a system of simultaneous equations and find a positive effect of democracy on growth through the channels of enhanced education, reduced inequality, and lower government consumption.

14. Most of the evidence presented in this section comes from Rodrik (1997, 1999b, and 1999c).
15. Similar findings have also been reported in Chandra (1998) and Quinn and Woolley (1998).
16. Each regression in this paper includes the following variables on the right-hand side in addition to those specifically discussed: log GDP per-capita in 1975, growth rate prior to break year, measure of external shocks during the 1970s, ethno-linguistic fragmentation (*elf60*), and regional dummies for Latin America, East Asia and sub-Saharan Africa.
17. A careful reader will notice that Rwanda – the scene of one of the most violent ethnic clashes in recent history – ranks at the low end of the ethnic fragmentation measure used here (*elf60*), which suggests that the measure in question leaves much to be desired. The reason for the ranking is that a single ethnic group constitutes the vast majority in Rwanda. I have not tried to adjust for apparent anomalies of this kind, so as not to introduce subjective biases to the analysis.
18. This literature is briefly surveyed and evaluated in Rodrik (1996).
19. Moreover, the estimated signs on these variables remain unchanged if the Freedom House index of democracy is entered separately in the regression.
20. The finding on political participation echoes the argument in Isham et al. (1997) that more citizen voice results in projects with greater economic returns.

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3. The effects of the interaction of formal and informal institutions on social stability and economic development*

Svetozar Pejovich

INTRODUCTION

We observe that the standard of living, economic stability, and growth rates are not the same in India and Japan, Germany and Portugal, the Czech Republic and the Ukraine. It is also apparent that exogenous shocks have different consequences in different countries. The opening up of the Americas produced varying economic outcomes in Spain and England. The end of colonial rule did more to increase the standard of living and stimulate economic development in Southeast Asia than in Africa. The end of Communist rule had a different effect in the Czech Republic than in Slovakia. Finally, we should also note that the same legal rules have different consequences on economic performance. Thus, according to Douglas North (1990):

> Many Latin American countries adopted the US Constitution (with some modifications) in the nineteenth century, and many of the property rights laws of successful Western countries have been adopted by Third World countries. The results, however, are not similar to those in either the United States or other successful Western countries. Although the rules are the same, the enforcement mechanism, the way enforcement occurs, the norms of behaviour, and the subjective models of the actors are not [the same].

The purpose of this chapter is to develop a testable theory, the interaction thesis capable of explaining why there are differences in economic stability and growth rates between various countries; or, stated negatively, why less-efficient countries do not duplicate the economic policies of more successful ones. The interaction thesis identifies the interplay of formal and informal rules as a principal factor affecting economic stability and growth rates.

Furthermore, the thesis also sheds light on how the method of choosing formal rules is a major circumstance upon which the interplay of formal and informal rules depends.

The new institutional economics provides the basis for the development of the interaction thesis. In order to explain this author's preference for the new institutional economics, several of the best-known competing alternatives are reviewed in the Appendix. In the first section of the chapter, a brief definition will be given of the key concepts and ideas of the new institutional economics. Then the interaction thesis will be developed and its effect upon social stability and growth will be analysed. Finally, the chapter will turn to empirical evidence in order to test for refutable implications of those effects in Eastern Europe.

BASIC PREMISES OF THE NEW INSTITUTIONAL ECONOMICS

While the new institutional economics is a fast-growing method for analysis of economic and social issues, it is also a young method still in the process of creating its own mainstream. Some scholars view the new institutional economics as an attempt to enlarge the competence of neoclassical economics to explain a larger class of real world events. Others consider neoclassical economics merely as a point of departure for redirecting economic analysis toward the effects of alternative institutions on economic behaviour. Thus, according to Libecap (1998),

> the new institutional economics retains its general attachment to neoclassical economics with its emphasis on individual maximisation and marginal analysis, but with attention to transaction costs, information problems, and bounded rationality.

Many economists, including this author, consider the new institutional economics to be a *sui generis* method of analysis with strong ties to the subjectivism of the Austrian School and Public Choice theory.

Social activity involves human interactions on two levels. The first concerns the rules of the game or institutions, while the second has to do with the game itself. This chapter defines institutions as the legal, administrative, and customary arrangements for repeated human interactions. The prevailing institutional framework in a society consists of formal and informal institutions; the major function of which is to facilitate exchange through predictable human behaviour in a world of uncertainty and incomplete knowledge. The two implications of that statement for economic analysis

are: (1) the rules matter, and (2) changes in the rules change the way the game is played.

Rather than emphasising the properties of various equilibria, the new institutional economics focuses on how alternative institutional arrangements facilitate economic stability and economic growth. Increases in knowledge, technological innovations, and other activities create new opportunities for gains. Those potential gains are realised through exchange, which, in a world of uncertainty and incomplete knowledge, is not without cost. By reducing the flow of resources into new and more valuable uses, positive transaction costs threaten to be a limiting factor on the rate of growth. Yet further analysis must answer this question: which set of institutions provides incentives for transaction costs to be reduced by those who can do it at the lowest costs, so that the gains from exchange can be realised. To pursue that and similar issues, the basic premises of our argument are as follows: (1) the effects of incentives on the rules and the feedback of their consequences replace the maximisation paradigm; (2) the competitive process creates knowledge; and (3) the selection process among discrete institutional alternatives replaces the assumption of a rational agent who is able to identify market equilibrium in each situation apart from any learning process. Rational expectation theory brings the new institutional economics and neoclassical economics into proximity but not to convergence. Furthermore, rational expectation theorists consider the process of adaptation to an optimal solution as a steady trial-and-error process in which the participants cease to acquire new knowledge. Simon (1978) wrote:

> [New economic theories] are not focused upon, or even much concerned with, how variables are equated at the margin, or how equilibrium is altered by marginal shifts in conditions. Rather they are focused on qualitative and structural questions, typically, on the choice among a small number of discrete institutional alternatives.

The four principal concepts upon which the new institutional economics rests are formal institutions, informal institutions, property rights, and transaction costs.

Informal Institutions

Informal rules are traditions, customs, moral values, religious beliefs, and all other norms of behaviour that have passed the test of time. Informal rules are often called the old ethos, the hand of the past, or the carriers of history. They embody the community's prevailing perceptions about the

world, the accumulated wisdom of the past, and a current set of values. Thus, informal institutions are the part of a community's heritage that we call culture.[1] They are maintained from one generation to another through various transmission mechanisms such as imitation, oral tradition, and teaching.

The enforcement of informal rules takes place by means of sanctions such as expulsion from the community, ostracism by friends and neighbours, or loss of reputation. In the process of enforcing informal rules, tribal chiefs and religious leaders have been (and in some parts of the world still are) known to use more severe forms of punishment.

Formal Institutions

Formal rules are constitutions, statutes, common law, and other governmental regulations. They determine the political system (i.e. the governance structure and individual rights), the economic system (e.g. property rights and contracts), and the enforcement system (i.e. the judiciary and the police). Governmental authorities enforce formal rules by means of sanctions such as fines, imprisonment, and execution.

Property Rights

Property rights are relations among individuals that arise from the existence of scarce goods and pertain to their use. They are not about the relationship between individuals and objects. The most common types of property rights today are private property rights, communal property rights, and state or public property rights. Institutions, in this framework, are like containers that hold property rights.

The more property rights a person has in a good, the closer his or her private cost is to the social costs of using that good, and the more incentives that person has for seeking the highest-valued use for the asset. That is, different property rights in goods create their own incentives through the impact they have on the relationship between the private and social costs of using those goods, which, in turn, affect human behaviour in specific and predictable ways.

Transaction Costs

Transaction costs are the costs of all resources required to transfer property rights from one economic agent to another. They include the cost of making an exchange (i.e. discovering exchange opportunities, negotiating exchange, monitoring exchanges, and enforcing agreements) and the cost

of maintaining and protecting the institutional structure (i.e. the judiciary, police, and armed forces).

INSTITUTIONS, INCENTIVES, AND TRANSACTION COSTS

From the viewpoint of individuals, institutions have their own benefits and costs. The benefit of a rule is the predictability of another person's behaviour. The cost of that same rule is the constraint it places on our behaviour. Those costs and benefits, which differ from one rule to another, create their own incentives and transaction costs affecting human behaviour. Informal rules emphasising the work ethic and thrift create incentives to accumulate wealth. Laws prohibiting abortions create black markets for abortions. The right to capture the entire profit from one's investment enhances risk-taking innovations. Rent controls reduce incentives to maintain privately owned apartments. Privately owned forests need no protection from overexploitation.

The pre-1996 welfare system in the United States is a good example of how institutions affect economic outcomes by way of incentives and transaction costs. The right to guaranteed income was the system's most critical rule. It gave single-parent families (predominantly single mothers) open-ended claims on the flow of cash and noncash benefits from welfare resources; that is, a welfare recipient had claims on the flow of benefits for as long as she maintained eligibility. In 1994, those benefits included about $7500 in cash and about $5500 in housing allowances, medical care, and other noncash benefits.

The right to guaranteed income created its own incentives affecting both moral standards and the work ethic. Welfare beneficiaries had incentives to pursue activities that would allow them to remain on welfare indefinitely, such as remaining a single parent, not looking for employment, disinvesting in human capital, and seeking covert work. The rule provided incentives for 'outsiders' to become single parents. Finally, the prevailing welfare system created incentives for rent-seeking coalitions to be formed in order to protect and enhance welfare rights.

However, the set of incentives arising from the right to guaranteed income created their own transaction costs. Those costs included the costs of bureaucratic overhead required to formulate the programme, to sell it to the general public, to administer it, and to enforce compliance. Other examples of such costs include the difference between the costs of resources required to provide non-cash benefits and the value of those benefits to welfare recipients,[2] not to mention the expenditure of resources that are outside of the welfare budget such as the costs of research grants to

universities and institutes in support of welfare studies, and police and court costs of enforcing welfare programmes.

Institutional Changes

The relationship between the rules and the game is a two-way street. The rules affect the way the game is played but are, in turn, affected by changes in the economic conditions of life. The following example is suggestive of the relationship between economic growth and institutional change.

The growth of output coupled with an enormous increase in the range of durable consumer goods changed the opportunity costs (i.e. relative price) of being a homemaker in the United States. But new opportunities for exchange were not in tune with the prevailing informal and formal rules. The prevailing rules expected men to specialise in earning incomes while women were expected to specialise in the efficient spending of that income and in raising children. Single women were socially marginalised. Wives went to work in order to pay some specific bills between pregnancies and after the children went to college.

An increase in the supply of females looking for work produced a predictable response in the market for labour. Given the high information costs of identifying career-oriented women, the market treated all women as a high-cost resource relative to men. Pressures on legislators from various feminist groups to equalise money incomes of men and women by fiat (e.g. equal pay for equal work) raised the transaction costs of monitoring and enforcing employment contracts without solving the real issue. The competitive market for labour was not discriminating by sex; it was responding, in a predictable way, to the prevailing standards of morality. In order to capture potential gains from joining the labour force, women had to press for institutional changes. The real issue was to remove the constraints of informal and formal rules, so that the competitive market for labour would have no reason to differentiate between men and women.

With some women earning differential returns at the cost of social ostracism and others following in their footsteps, the pressure for change in the rules came from within the system. Eventually the rules began adjusting to the new requirements of the game. Today, we observe change in informal rules, which provide social acceptance for the Pill, single motherhood, and live-in arrangements, not to mention change in formal rules that permit abortions and simplified divorce proceedings.

It is my thesis that those changes in formal and informal rules are not a consequence of lower moral standards in the United States but the result of economic growth that has created new opportunities for gains. Thus, changes in formal and informal rules were necessary in order to exploit

those potential gains. One can think of the social and economic consequences of those changes as the cost of economic growth.

Formal and Informal Rules: Conflict or Cooperation

We must now address the relationship between formal and informal rules, which is by no means a new question.[3] However, what is new is the systematic treatment of the relationship between formal and informal institutions.[4] The following observable relationships between formal and informal rules are critical for the verification of the interaction thesis.

First, formal institutions can suppress but they cannot change informal institutions. McAdams (1997) suggests that formal rules can change informal rules. He refers to laws restricting smoking, bans on duelling, and anti-discrimination laws in the United States. An alternative explanation is that informal rules on smoking, duelling, and discrimination had already begun changing, so that new formal rules only institutionalised the ongoing process into the legal framework. The problem with McAdams's proposition is that we observe many more cases in which formal rules have failed to change informal rules. Similar formal rules in the United States and South America have produced different outcomes because informal rules in South America have failed to change. Japanese culture has survived American (or Western) laws of commerce. Serbs (and countless other ethnic and religious groups) preserved their informal institutions through five centuries of Turkish formal rules. The rise of 'ghettos' in American cities reflected a strong preference of ethnic, racial, and religious groups – all living under the same formal rules – to maintain their respective cultures and stay close to those whose behaviour they could understand and predict.

Second, formal rules are in direct conflict with informal rules. The difference between formal rules suppressing informal rules and being in conflict with them is merely one of degree. Recent developments in the 'religions market' in Russia is a good example of how the conflict between formal and informal rules may arise. The Russian Orthodox Church has had a monopoly in the market for religion since the time of Ivan the Terrible (1547–84). The Romanovs (1613–1917) used the legal system to protect the Russian Orthodox Church from competition by other churches. Communists leaders abetted this protection by raising the cost of entry into the market for religion. The result was that the Russian Orthodox Church became (or came to consider itself) the guardian of Russian customs and traditions.

In recent years, many Protestant denominations have found the market for religion in Russia receptive to their religious and ethical norms of behaviour. In response to this demand for other religions, the Russian

Orthodox Church lobbied the state to pass laws prohibiting (or at least seriously restricting) other churches from marketing their services. If this does not occur, the Russian Orthodox Church insists that Russian religious life and culture will be Westernised or destroyed, which in the eyes of that church are one and the same thing. Of course, the argument is merely the façade of words hiding the church's true purpose, which is to use the law to preserve its monopoly position at the price of restricting voluntary changes in informal rules.

Third, formal rules are either ignored or rendered neutral. McAdams cites several sources documenting that individuals sometimes find the costs of making informal arrangements lower than the costs of depending on formal rules to resolve specific problems (Bernstein, 1996). He discusses Lisa Bernstein's analysis showing that American merchants generally prefer to resolve their disputes without resort to the expensive legal system for enforcing contracts, and Robert Ellickson's research on how ranchers in Shasta County, California, 'enforce informal rules for disputes involving cattle trespass and boundary fences and thus resolve certain conflicts without the legal regime' (Anderson and Hill, 1983; Libecap, 1996). A visit to a village in Montenegro could easily confirm McAdams's analysis.

Finally, formal rules and informal rules cooperate. Formal and informal rules can and often do coexist in harmony. Such formal rules are sustainable at low monitoring and enforcement costs. Some examples of formal rules are those that protect one's reputation, one's life and property, and so forth. Research into the development of property rights in the American West is a good example of the state institutionalising informal rules into the legal system, which emerged spontaneously in response to the development of new opportunities for economic gains (Bauer, 1988).

THE INTERACTION THESIS

So far our analysis has suggested that (1) institutions develop their own incentives and transaction costs; (2) institutions and economic outcomes are linked through the effects of the former on incentives and transaction costs; and (3) informal and formal rules change because some specific individuals and/or organised groups perceive that their benefits exceed the costs of institutional restructuring. The interaction thesis, which is stated in the following paragraph, derives from those three propositions:

> If changes in formal rules are in harmony with the prevailing informal rules, the interaction of their incentives will tend to reduce transaction costs in the community (that is, the cost of making an exchange and the cost of maintaining and

> protecting the institutional structure) and clear up resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the interaction of their incentives will tend to raise transaction costs and reduce the production of wealth in the community.

Various observations support this thesis. For example, it explains why enormous resources were required to maintain and enforce the Communist regimes in Eastern Europe. Furthermore, it explains the differences in economic development between Catholic and Protestant countries in Europe, North America, and South America, as well as the differences in the transaction costs of enforcing anti-abortion laws in religious and less religious communities. Prohibition laws in the United States clearly conflicted with the country's prevailing tradition of social drinking. People such as Al Capone served the important social function of giving people what they wanted but at a price. Eventually, the high transaction costs of maintaining and enforcing prohibition laws helped to convince the government to eliminate the conflict between formal and informal rules concerning the consumption of liquor. People who went to jail for selling liquor in one year were contributing to the country's GNP the following year. Verification of the interaction thesis, however, requires more than casual observations. It requires analysis of (1) the process for making rules, (2) the rule makers' incentives, and (3) the effects of those incentives on transaction costs.

Rule-making: Informal Institutions

It is fair to assert that in the pursuit of survival, individuals discovered the importance of human interactions. Some interactions were repeated over and over again not because individuals understood them but because they worked. Eventually, those interactions that had passed the survival test were institutionalised into taboos, traditions, moral values, beliefs, and so forth. That is why informal rules are not a policy variable. They change primarily through their erosion, which is a slow and time-consuming process. Suppose a new idea hits a community. An important economic consequence of the idea would be to enlarge the set of opportunity choices for human interactions. However, if new exchange opportunities were not in tune with the prevailing ethos, the community would consider the behaviour of those exploiting the opportunities as submarginal. But if operating below the margin of accepted behaviour provided a differential return, the success of those individuals doing so would attract competition from others. And if the returns were substantial enough to generate and sustain a large number of repeated interactions relative to enforcement costs, the very success of new activities would compel informal institutions to adjust

in order to embrace the novelty. The behaviour that used to be submarginal would eventually become marginal (or intra-marginal).

Some communities are dominated by informal rules. We call them traditional communities. Their major (and predictable) features are social stability and economic stagnation. Peter Bauer's research on economic and social development in British Africa shows that the transformation of traditional communities into the modern state could have a high price tag.

Bauer said that until the process of decolonisation began in the late 1930s, British rule in Africa was based on the principles of limited government, open economy, and non-interference with the authority of tribal chiefs in their villages. In general, the British found it to be in their self-interest to maintain the flow of life consistent with the prevailing informal institutions in Africa. While some tribal chiefs might be more capricious than others, they were all constrained by customs and traditions. A critical consequence of decolonisation was that British-educated Africans replaced tribal chiefs. In order to centralise political power and embark on economic planning for growth, the educated élite ignored traditional values in favour of formal rules. Being in direct opposition to the prevailing informal institutions in Africa, new formal rules ended up replacing the old ethos with political corruption, social instability, and economic failures (Easterbrook and Fischel, 1991).

Rule-making: Formal Institutions

Formal rules are enacted, changed, and enforced by legislators, judges, bureaucrats, and other rule-makers. That is, formal rules are a policy variable. New formal rules may emerge in response to the requirements of the game. Or rule-makers could pass new rules in order to change the game. The emerging convention is to refer to the former as spontaneous changes or changes from within the system, and to the latter as changes from without.

Formal rules emerge spontaneously in response to changes in the economic conditions of life (for example, new markets, new knowledge, new sources of supplies, and so on). Changes in the economic conditions of life create new opportunities for human interactions. In order to exploit those opportunities, individuals seek new contractual arrangements. Contractual arrangements that pass the market test create the demand for institutional change that promise to lower the transaction costs of exploiting new opportunities. New formal rules that emerge from this process should then be in tune with the prevailing informal institutions. Otherwise, voluntary contractual agreements leading to the demand for adjustments in the rules would not have happened. An implication is that the community that provides an environment conducive to spontaneous changes in formal rules

should be both stable and growing. Many formal rules in the United States, such as the rule of limited liability, the right of ownership in the American West, and stock exchanges have emerged in response to the economic forces at work.[5] Formal rules that are imposed from without (in order to change the game) may or may not be in conflict with informal rules. A great deal depends on the incentive structures under which rule-makers operate, and the effect of the prevailing political order upon those incentives.

We can classify all countries as belonging to one of four basic types of political order: liberal democracy, liberal autocracy, illiberal democracy, and illiberal autocracy (Buchanan, 1975). Liberalism and democracy are two critical concepts underlying those four political arrangements. Democracy is about the right of individuals to organise into political parties, the holding of free and fair elections, and the process of selecting a government. Liberalism is concerned with the rule of law, stable and credible property rights, and civic and economic freedoms. While democracy is concerned with who has power, liberalism focuses on the limitation of government's power. The liberal state is one in which the law protects individual rights against the collective (majority) will. Thus, the liberal state creates incentives for individuals to pursue self-interest, self-determination, and self-responsibility. Two good examples of liberal democracies are the United Kingdom and the United States where individual rights are generalised from specific decisions (precedents) entered by common law courts. According to Buchanan, 'The object of never-ending search by loosely coordinated judges acting independently is to find the law, to locate and redefine the structure of individual right, not *ab initio*, but in existing social–institutional arrangements' (Pejovich, 1997). That is, legal precedents tie changes in the rules to changes in the game.

Public Choice scholars have addressed the problem of evaluating the incentive structures of different political orders. However, the evidence for refutable implications of those effects on the behaviour of public decision-makers is yet to be developed. A promising approach for evaluating the effects of formal rules imposed from without is described below.

Suppose the leaders of a country decide to make a major change in that country's formal rules, such as Lyndon Johnson's Civil Rights Bill of 1964, prohibition laws, rules on abortion, codetermination laws in Germany, or privatisation programmes in Eastern Europe. A new rule signals the ruling élite's intentions to restructure the prevailing institutional arrangements. However, if that rule is out of harmony with informal institutions, people will view it with apprehension, uneasiness, and even outright hostility. Higher costs of integrating the rule into the prevailing framework of property relations should force public policymakers to pass clarifying rules and regulations (hereafter: secondary laws), which attempt to harmonise basic

formal rules with prevailing customs, traditions, and moral values, or instead to clear the way for their enforcement.

Secondary laws and regulations consume current wealth. They also reduce the production of wealth in the future by creating a perception of frequent legal changes. Thus, the number of secondary laws that have to be passed in order to clarify and enforce an important formal rule can be taken as a proxy for its effect on transaction costs; that is, the number of secondary laws depends on the reaction of the prevailing informal institutions to the new formal rule.

THE INTERACTION THESIS AND THE TRANSITION IN EASTERN EUROPE

A useful simplification for analysing the transition in Eastern Europe is to refer to liberal democracies and liberal autocracies as 'the rule of law states', and to illiberal democracies and simple dictatorships as 'the arbitrary states'. The former means credible absence of arbitrary use of power on the part of the ruling group, while the latter implies arbitrary use of power by the ruling group. With a few possible exceptions such as the Czech Republic, Estonia, Hungary and Poland, all former communist countries in Eastern Europe and the former Soviet Union should be considered arbitrary states.

The Arbitrary State and its Implications

As socialist rule ended, Eastern Europeans needed stable rules for carrying out interactions among themselves and with the rest of the world.[6] An important question to which we now turn is whether new formal rules in Eastern European countries, as they interacted with the old ethos, created incentives that raised or lowered transaction costs.

Informal rules in Eastern Europe are not homogeneous but they do have some common traits. The old ethos in Eastern Europe has been largely free of such Western ideas as classical liberalism and methodological individualism. Although those nations that belonged to the Austrian Empire have more of a Western tradition than other Eastern European countries, yet classical liberalism, which is only one part of that tradition, does not have deep roots in the region. The prevailing concept of the community has a strong bias toward collectivism and egalitarianism. This bias raises the transaction costs of identifying and accepting alternative institutional arrangements. Moreover, the communities in the region have developed customs and common values along ethnic lines. Frequently, a person's

ethnic origin predicts that the person's religion – usually Islamic, Roman Catholic, or Eastern Orthodox – will reinforce basic differences in customs and values among ethnic groups. Interactions within most ethnic groups are thus subject to rules of behaviour that do not necessarily apply in dealings across ethnic lines.

The old ethos in Eastern Europe, then, clashes with capitalist culture, which emphasises self-interest, self-responsibility, self-determination, puts a premium on the rules that reward performance, cultivates risk-tasking attitudes, values the maintenance of individual liberties, and makes the keeping of promises important for accumulating wealth. In 1989, Eastern Europeans needed time to learn that capitalism is not merely an alternative mechanism for the allocation of resources, but a way of life in which individuals voluntarily interact with one another in the pursuit of their private ends and in so doing create a culture *sui generis*. Forcing Eastern Europeans to accept the institutions of capitalism before they had become comfortable with the system's culture inevitably created a conflict with the old ethos.

As new leaders in Eastern Europe, with considerable support from the West, used the strong hand of the state to build capitalism they basically replaced the old conflict between socialist institutions and the region's ethos with a new one. The new conflict created an opportunity for two groups, former nomenclaturists and older people, to seek personal gains through the machinery of the state. However, by pursuing their self-interest, those two groups produced some unintended consequences, which have affected the character of social, economic and political life in Eastern Europe since the mid-1990s. One such consequence is the rising strength of pro-collectivist parties in the region.

Former Nomenclaturists

As socialist rule ended in Eastern Europe, former leaders had incentives to seek ways to preserve their power and privileges. Their human capital equipped them for seeking advantages in a bureaucratic environment; therefore, the transition to the free-market, private-property system threatened their well-being. To preserve the value of their human capital, former nomenclaturists, while paying lip service to free-market reforms had to maintain or recreate a state-centred system. They knew that encouraging the perception of an external threat to their respective ethnic groups would give them a good chance to stay in power. Most former nomenclaturists, then, quickly transformed themselves into nationalists. Indeed, most leaders in the multi-ethnic states of Eastern Europe in the early 1990s were communists. Examples include Milosevic in Serbia, Kucan in Slovenia, Meciar in Slovakia, and Kravchuk in the Ukraine. Switching to capitalism

was easy for them because nationalism and socialism have one important common trait – namely, the collectivist mode of looking at the world (Pejovich, 1994).

Older Workers and Retirees

Under socialism, Eastern Europeans had no opportunity to save or to invest in privately owned assets. Instead, the state provided them with assets specific to a non-private-property economy, including (1) a variety of welfare benefits such as job security, allowances for children, medical benefits, and subsidised housing; and (2) opportunities unique to the shortages that were a major characteristic of socialist economies in Eastern Europe and the former USSR. Retired people and older workers find the returns from those assets irreplaceable.

Older workers see the institutions of capitalism as a threat to their current and future benefits from the system-specific assets. For good reason, they fear that the remainder of their working life is too short to allow them to replace the lost benefits by means of private savings and investments. Retired people have experienced a decline in the value of their pensions and other benefits. Moreover, in economies characterised by chronic shortages of all consumer goods, retirees were an important asset to their families in two ways. First, they had time to wait in line for consumer goods. Second, they specialised in knowing what goods would be available, where, and when. Thus, retired people raised the real incomes of their extended families. As market-clearing prices replace controlled prices, retired people fear that they will become a liability to their families.

Older workers and retirees have incentives to perceive the institutions of capitalism as a real threat to the value of their assets. They did not purchase the socialist welfare package by choice, but that is all they received. Accordingly, many Eastern Europeans, whatever their ideological preference, are hostile to capitalism for reasons of self-interest; whereas young people, by contrast, who have made little or no investment in the old system's specific assets, strongly support the transition to capitalism.

IN LIEU OF CONCLUSION

The imposition of new formal rules that were not in harmony with the prevailing informal institutions in Eastern Europe has provided incentives for rent-seeking coalitions to be formed, and those coalitions have played a major role in subverting the transition from socialism to capitalism. Nomenclaturists and elderly people adroitly exploited the old ethos to their

advantage and pushed most Eastern European countries, including those that were part of the former USSR, in the direction of arbitrary states (either illiberal democracies or dictatorships). The current crisis in Russia is but one manifestation of the economic problems in the arbitrary states of Eastern Europe.

Nevertheless, some spontaneous institutional changes have been occurring in Eastern Europe. Of the thousands of small private firms that have sprung up, many have failed or will fail, but many will survive and grow. Those enterprises are performing a vital function that privatised state enterprises do not and could not perform. They serve as the breeding ground for entrepreneurs, a work ethic, a capitalist exchange culture, and positive attitudes toward capitalism in general. They educate ordinary people to appreciate a way of life that rewards performance, promotes individual liberties, and places high value on self-responsibility and self-determination.

The interaction thesis suggests that instead of building capitalism by fiat, Eastern European governments should try to provide – admittedly by fiat – a legal environment that would allow people to choose among alternative institutional arrangements, that is, to participate in a market for institutions. This would predetermine neither a specific transition path in Eastern Europe nor the rate of institutional change. As I have argued elsewhere (Stahl, 1999), the market for institutions would give people a chance to learn about the institutions of capitalism, try them out, and select those that perform well. Silke Stahl has aptly summarised this notion:

> The transition process in Middle and Central Europe has clearly not been entirely spontaneous, yet the diverse outcomes of the transition processes in various countries also show that it is not feasible to design an economic system on a drawing board; prior developments constrain future change. (Schotter, 1983)

APPENDIX: ALTERNATIVE METHODS FOR ECONOMIC ANALYSIS

Classical Economics

Classical economists understood that social stability and economic growth depend on an increase in knowledge, private property rights and open market competition. Unfortunately, classical economists, specifically David Ricardo, succumbed to the assumption that an increase in knowledge will not be sufficient to offset the law of diminishing returns in the production of goods. Thus, classical analysis failed to predict the sustained economic growth of the West throughout the twentieth century.

Marxism

Karl Marx rejected Ricardo's doomsday predictions. Marx's vision of the ability of scientific progress to offset the law of diminishing returns was correct. On the other hand, Marx's economic analysis was quite primitive. Thus, it explained little and predicted nothing. Profits in capitalist countries show no tendency to fall, the reserve army of unemployed workers is yet to be born, the ownership of capital has been diffused, and the rate of entry by small firms has been rising. While Marx's predictions about the future of capitalism failed to materialise, his teaching was directly responsible for the socialist experiment; perhaps the costliest experiment in human history.

Keynesian Economics

In the late 1940s and early 1950s, the majority of intellectuals believed that high growth rates required both high public expenditure and substantial governmental controls of the economy. To justify public expenditure and governmental controls, it was necessary to assume that the social welfare function exists, that government leaders know it and that they can be trusted to implement it selflessly. Predictably, the outcome of public expenditures and governmental controls in the 1960s and 1970s was higher unemployment, higher inflation and less growth.

Planning for Development

Failures of public policy in Less Developed Countries was attributed to a variety of 'objective' factors such as an inadequate resource base, shortage of capital, exploitation by their former colonial rulers, and poor economic planning. None of those reasons is fully adequate. As the colonial rule ended in the late 1940s and 1950s, the economies of most countries in Africa and Southeast Asia were nearly equal. Today, however, most Southeast Asian countries are doing well, while many African countries seem to be in no better economic shape than they were at the time they became independent states. Evidence does not support the claim that an inadequate resource base explains the low rate of economic growth. Much depends on what is done with the resources people happen to have. To attribute economic problems in India, Bangladesh, and China to overpopulation is refuted by a look at the economic performance of Japan, the Netherlands, and Hong Kong. In comparison with the Czech Republic and Belgium, Russia and the Ukraine are resource-rich but performance-poor. Economic development is also not held back by a shortage of capital. Political instability, currency controls, restrictions on the right of ownership, non-credible legal institutions,

discriminatory taxes, and corrupt governments hold back the flow of private capital. There has been no shortage of capital in Southeast Asia compared to Africa, or in Hungary and the Czech Republic compared to Belarus and Bulgaria.

Neoclassical Economics

Neoclassical economics has been the most influential method for analysis of economic issues since the 1930s. It has immensely enriched our understanding of the economic forces at work. However, the basic assumptions of neoclassical economics hamper its ability to explain a wide range of real world events. Those assumptions are maximising behaviour, stable preferences, and market equilibrium. The first assumption ignores the transaction costs of identifying and pursuing maximising behaviour; the second assumption ignores that preferences do not exist independently from the knowledge-creating process of exchange through which they are generated; and the third assumption directs analysis away from the process of adaptation and toward the search for unique solutions in a world of many different property rights, positive transaction costs, and incomplete knowledge. The ability of neoclassical economics to explain real world observations is limited, as Schotter wrote:

> . . . The only institutions existing in [the neoclassical model] are markets of the competitive type in which all information on the economy must be transmitted through the prices formed in these markets. The economy is therefore assumed to have none of the many social institutions that are created by societies to help coordinate their economic and social activities by offering information not available in competitive prices.

NOTES

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1. Douglas North (1990: 37). Also E. Gellner (1988), who defined culture as 'a distinct way of doing things which characterises a given opportunity', p. 14.
2. For example, a rent subsidy that costs taxpayers $4000 would generally be worth less than $4000 to the recipient of that subsidy because $4000 in cash offers a greater range of choices. That is, if the recipient of welfare received $4000 in cash and chose to spend all or some of that sum of money on other goods, his behaviour would reflect that he valued $4000 worth of housing less than another bundle of goods that $4000 can buy.

3. An article by Goetz Briefs was an early attempt to look into the history and development of the relationship between formal and informal rules. See Goetz Briefs (1957). I have touched upon this subject in Pejovich (1968).
4. R. Cooters, R. Ellickson, J. Landa, R. McAdams and others have made major analytical and empirical contributions to the relationship between formal and informal sanctions.
5. For a detailed analysis, see Zakaria (1997). Liberal democracies are best characterised not by free elections but by the rule of law and an impartial judiciary; that is, by stable and credible individual rights. The main features of liberal autocracies, such as Hong Kong (before the city was taken over by China), Singapore and Taiwan are few political freedoms, the rule of law and credible individual rights. Illiberal democracies, which are characterised by free elections and little respect for the rule of law, are taking over the world; 118 of the world's 193 countries are democratic. In those countries, civil liberties are eroded and governments rule by decree (as does Yeltsin in Russia). We observe 'a spectrum of illiberal democracy, ranging from modest offenders like Argentina to near tyrannies like Kazakhstan and Belarus, with countries like Romania and Bangladesh in between'. The main features of illiberal democracies, such as North Korea, China, Cuba and some Gulf States, are the absence (to various degrees) of both political freedoms and individual rights.
6. In general, nationalism embraces the conviction that the community's common good transcends the private ends of its members. This implies that individuals can attain their greatest potential only through their national identity. Nationalism is thus incompatible with individual liberty and competitive markets.

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4. Globalisation, democracy and citizens' sovereignty: can competition among governments enhance democracy?[1]

Viktor Vanberg[2]

INTRODUCTION

The expansion of markets known as globalisation creates new options; new avenues for trade in goods and services, as well as new opportunities for capital investment and the allocation of mobile resources. It is a common and uncontested claim that globalisation and the resulting competition among jurisdictions impose restrictions on the freedom of action of national governments.[3] Competition is always a matter of accessibility of alternative options, and to the same degree that the globalisation of markets creates additional options for citizens and for those whom one may call 'jurisdiction-users',[4] competition among jurisdictions restricts the power governments can exercise over them. Governments cannot with impunity ignore the greater scope for choice that globalisation offers to their citizens and to jurisdiction-users.

The point at issue is how this restriction of the power of governments should be evaluated. The argument that competition among jurisdictions can serve common interests of citizens, and is from their standpoint a welcome development, is stressed by authors like Geoffrey Brennan and James M. Buchanan (1988), who see the vulnerability to privilege-seeking or rent-seeking as a fundamental weakness of the political decision-making process. In their view competition between governments can provide a potential remedy by limiting government's scope for granting privileges, thereby reducing the incentives for rent-seeking. The counter-argument, that competition among jurisdictions obstructs or can even prevent the realisation of the collective interests of citizens, is stressed by authors like Fritz W. Scharpf (1998) or Hans-Werner Sinn (1994; 1997a). They emphasise potential negative incentive effects of competition among jurisdictions,

and the danger that it can lead to 'ruinous competition between states' (Sinn, 1995), with undesirable consequences for all parties involved.[5]

The focus of the present chapter is on an argument frequently heard in this context, namely that the developments referred to as globalisation represent a threat to democracy, and that there is a systematic conflict between the market forces of competition among jurisdictions and the principles of democratic politics.[6] To examine this argument, it is first necessary to clarify what is to be regarded as the defining principle of a democratic polity, and which performance criterion should, accordingly, be used to assess democratic politics. This question must be clarified before one can proceed to a meaningful discussion of how the effects of competition among jurisdictions on politics are to be evaluated in terms of the postulated criterion.

STATE, 'JURISDICTION ENTERPRISES' AND DEMOCRACY

What are the 'entities' that compete with one another in competition among jurisdictions (Vanberg and Kerber, 1994)? In the current debate on globalisation, nation states are generally, explicitly or implicitly, understood to be the competing units. The term 'jurisdiction' can, however, also be interpreted in a broader sense to include other kinds of political communities, at the sub-national as well as at the supra-national level, to the extent that they command power to set and enforce rules and regulations governing people living or working in their respective territories. If we think in terms of nation states, we tend to imagine that the world is divided into political entities, each exercising exclusive state power over a certain area. If we think in categories of jurisdictions in the more general sense, a considerably more complex image of diversely overlapping jurisdictions emerges, comprising, in addition to nation states, political entities at the sub-national and supra-national level, among which authority is divided and each of which is in control only over a certain domain of issues. At the sub-national level, these are communities or Länder within federal states, and at the supra-national level these are entities such as the European Union. Even if nation states indisputably enjoy a special status within this framework, when we speak of 'competition between jurisdictions' it is important to take into account that the authority for shaping the characteristics of a territorially defined unit by political means can be divided up among various jurisdictions. For the sake of simplicity, one may read the arguments that follow as if they refer to nation states as the units involved in the 'competition among jurisdictions'. They are meant, though, to apply,

appropriately adjusted, to jurisdictions in general, i.e. to sub- or supranational political jurisdictions as well.

For the present purpose it is useful to think of states (or jurisdictions) as 'territorial enterprises' in the sense that they are viewed with respect to their role as organisations, that provide packages of jurisdiction services and characteristics for the inhabitants and users of their respective territorial domains, packages that include such things as infrastructure, legal security, social legislation, environmental standards, tax regulations, and so on, i.e. all the properties of a jurisdiction that are a potential subject of political choice. Just as enterprises compete for customers by offering their respective price–benefit packages, states or jurisdictions as 'territorial enterprises' find themselves competing with their tax–benefit packages for 'jurisdiction customers', i.e. inhabitants and jurisdiction users.

If we view states as territorial enterprises in the noted sense, we can characterise democratic states as cooperatives, that is as 'territorial enterprises' which are owned by their members, their citizens. The defining characteristic of democratic polities is that their members or citizens are the principals or ultimate sovereigns. And just as it is, in general, the purpose of cooperatives or member-owned organisations to promote the interests of their members, we can say that democratic polities, as associations of citizens, should serve the common interests of their members, the citizens.

Accordingly, their performance or efficiency ought to be measured by how well they enable their citizens to realise mutual gains. The criterion for the efficiency of democratic polities in this sense may be defined as citizen sovereignty, in analogy to consumer sovereignty as a criterion for the efficiency of markets.

Consumer sovereignty means that the economic process should be organised – or be framed by rules – in such a way that producers are made most responsive to consumer wants. In other words, consumer sovereignty describes the ideal of an economic process in which consumer wants are the principal controlling variable. By comparison, citizen sovereignty means that the political process should be organised – or be framed by rules – such that the 'producers of politics' are made most responsive to citizens' wants. In other words, citizen sovereignty describes the ideal of a political process in which citizens' wants are the principal controlling variable. Consumer sovereignty is a purely procedural criterion. It does not apply directly to the outcomes of market processes but to the procedures through which they come about. In the same sense, citizen sovereignty is a purely procedural criterion. It does not apply to the outcomes of political processes *per se*, but to the nature of the processes that generate them. Ensuring citizen sovereignty means to organise a democratic polity, or to provide it with a constitution, such that the government is, on the one hand, equipped to implement

schemes which benefit all citizens, while it is, on the other hand, prevented, as far as possible, from acting against the interests of some or even all of its citizens.[7]

Whether competition among jurisdictions poses a 'threat to democracy' obviously depends on what we consider the relevant performance-criterion for democratic polities. If we assume what a majority of elected officials approves to be desirable expression of 'democracy', the obvious and easy conclusion is that competition among jurisdictions must be 'detrimental to democracy' to the extent that it prevents or restricts governments from carrying out measures that can command such majority approval. By contrast, if we measure the efficiency of democracy in terms of the noted criterion of citizen sovereignty, then we cannot simply draw such conclusions. Instead, we must first examine whether the restrictions imposed by competition among jurisdictions do, in fact, impede governments in their task to promote the common interests of their citizens.

The extent to which democratic polities genuinely satisfy the criterion of citizen sovereignty depends on how well their organisational structure or constitutional provisions help to solve two problems. They should, on the one hand, enable the organised citizenry or its executive organ, the government, to carry out projects that serve the interests of all citizens ('enabling constitution'). On the other hand, they should restrict the decisionmaking powers conferred on the polity so that they cannot be used against the interest of some or all citizens ('limiting constitution'). In short, the function of democratic political constitutions is to make the citizenry, on the one hand, capable of acting collectively to realise common benefits, and on the other, to provide protection against exploitation. The 'constitutional calculus' weighing up these two problems is, of course, what James M. Buchanan and Gordon Tullock (1962) have described as the 'logical basis of constitutional democracy', in one of the best-known Public Choice classics.

In light of the two noted risks, the risk of political measures not being undertaken that would, in fact, serve the common interests of all citizens, and the risk of political measures being undertaken that run against the interests of part or all of the citizenry, the principle of citizen sovereignty implies that all constitutional provisions – or other constraints – should be unequivocally welcome that reduce one risk without increasing the other, or that bring the two risks in a more labourable balance, as judged by the citizens themselves. In other words, the principle of citizen sovereignty can be defined as the ideal that the political process should be constrained by constitutional rules or other provision such that the two risks are brought into what the citizens themselves consider to be the most favourable balance.

In a democratic system in which no one is entitled to a privileged vote (apart from the special decisionmaking powers of delegates specifically appointed by citizens or principals), the risk of undesirable decisions would obviously be most effectively reduced by a unanimity rule, which would give each member a right of veto on all issues. The downside of this rule is, of course, that while guarding against the risk of undesirable decisions, it dramatically reduces the chance of *any* decision being taken, including ones which would actually benefit all members.[8] This danger would, in turn, be minimised by a rule that grants any single member the right to make binding decisions for the polity. Yet, since the democratic requirement of equal decisionmaking rights for all citizens would mean that this right applies to all citizens equally, such a decision rule would, from the perspective of every single member, maximise the risk of decisions being made that run against his interest. In order to escape from this calamity, it is in the interests of all citizens to agree on constitutions for their polities, which allow for majority decisions and the delegation of decisionmaking powers, even if this inevitably implies the possibility of measures being taken that will violate their interests. This does not mean at all abandoning the reference norm that, as citizens' associations, democratic polities should serve the common interests of all members. It simply means to take account of the trade-off between the two noted and of the costs that complete protection against any violation of one's interests would entail. The criterion of promoting the interests of all is – so to speak – moved to a higher or more general level: since it is not practical, namely subject to too many disadvantages, at the level of particular political decisions, it is applied at the constitutional level where the rules for making policy choices are chosen. At this level the crucial question is: among the feasible alternatives, which constitutional arrangements or decision rules best serve the common interests of all, even if they must be expected to allow for decisions which are not in the interests of all.[9]

In relation to the issue of 'competition among jurisdictions and democracy', this implies that we must examine how the constraints that competition among jurisdictions imposes on governments affect the risks outlined – the risk of undesirable decisions being made and the risk of decisions which would benefit all not being made. In examining this issue, we must bear in mind that the reducing of either risk not only involves interest-related problems, but also serious knowledge problems. There is not only the problem that the realisation of the common interests of all citizens might be impeded or prevented because political agents use the decisionmaking powers vested in them to pursue personal interests at the expense of citizens' interests, or because parts of the citizenry use the political process to achieve unilateral gains at the expense of others. Rather, there is

the additional problem that it is not always apparent where the common interests of citizens lie, or how to serve them in the most efficient and cost-effective manner.[10] Any assessment of the effects of competition among jurisdictions must take both the knowledge problem and the interest problem into account.[11] Since the discovery of common citizen interests and the best methods of advancing them depends on the initiative of political entrepreneurs and the ability of citizens to assess relevant alternatives, competition among jurisdictions can – apart from its motivating force – play a useful role in generating information to help political entrepreneurs solve problems, and to facilitate citizens' evaluation of political performances by providing them with standards of comparison.[12]

CITIZENS AND JURISDICTION USERS

In discussing the effects of competition among jurisdictions, the focus is often on the distinction between mobile and immobile factors, with the stress on the fact that competition among jurisdictions favours mobile factors above immobile factors, or more generally speaking, that factors are favoured in proportion to their degree of mobility.[13] The intensifying of the competition among jurisdictions witnessed in recent years has to do with the fact that technological, political and institutional changes have made economic options beyond national boundaries increasingly accessible. It is obvious that factors can avail of these options to the degree of their own mobility, with corresponding consequences for their relative bargaining powers. This means, of course, that, as the sceptics claim, competition among jurisdictions does not equally favour mobile and immobile factors. However, it does not imply, as is sometimes suggested, that the less mobile factors would be better off if competition among jurisdictions would not have intensified, or that they could be made better off if they used the political process to obstruct more mobile factors from using the options created by competition among jurisdictions. Whether this is the case or not cannot be established without further examination.

As relevant as it surely is for other purposes, the distinction between mobile and immobile resources is *per se* not relevant for the present issue, i.e. the relation between competition among jurisdictions and democracy. If democratic polities are to be viewed as associations designed to advance the common interests of their members or citizens, the question of how competition among jurisdictions affects the interests of mobile and immobile factors is *per se* not relevant for this issue. It is not either of the latter interests, but the interests of the citizens which provide the relevant standard for evaluating the effects of competition among jurisdictions and for

judging the desirability of potential political reactions. From this perspective, the relevant contrast is not between mobile and immobile factors, but between citizens and those jurisdiction users who, as non-citizens, live or conduct business within a jurisdiction. Needless to say, the two distinctions are, as a matter of fact, not entirely independent of each other. In particular, one should expect the combinations 'citizens/immobile factors' and 'jurisdiction-users/mobile factors' to occur disproportionally often, a fact that has to be taken into consideration in analysing the effects of competition among jurisdictions. Nevertheless, it has to be kept in mind that only the ability of governments to promote the common interests of their citizens provides the decisive criterion against which we can judge whether there is a conflict between competition among jurisdictions and democracy. The interests of non-members as jurisdiction-users are *per se* of no systematic relevance. Note, however, that this by no means implies that the interests of non-citizens as current or potential jurisdiction-users can be neglected without impunity. They are irrelevant only in so far as the performance criterion for democratic associations is the promotion of members' interests, not the promotion of the interests of non-members. The latter's interests certainly do play an indirect role, however, to the extent that the citizens or members of polities have, with regard to their own interests, good reasons to take the interests of such non-members into account, in more or less the same way as the owner of a firm must – if he wants to run a successful business – consider the wishes of his clients, suppliers, creditors and employees.

In addition to the above-mentioned indirect consideration, which we will return to later, the interests of the members of other jurisdictions can, of course, also gain direct importance, especially in cases concerning potential agreements (on rules) between states or jurisdictions. In order to assess the desirability of such international or inter-jurisdictional agreements, it is obviously not only the interests of the citizens of any single jurisdiction that are at stake, but also the interests of the citizens of all participating jurisdictions. This fact will be discussed below in more detail in connection with the issue of the 'rules of competition' for competition among jurisdictions.

Before examining the effects of 'competition among jurisdictions', a few remarks are in place to clarify the concept itself, since it is used in a variety of contexts. It is sometimes used, for example, to refer to the fact that through their infrastructural resources and institutional frameworks, jurisdictions influence the costs of the domestic production of tradeable goods and services, and consequently, the competitiveness of domestic producers on the global market. In this sense, jurisdictions compete with their characteristics indirectly, in so far as these affect the chances of domestic producers in international trade. As it is used most often, however, the concept

of competition among jurisdictions does not refer to this 'indirect' form of competition, but to the direct competition for people and mobile resources.

Jurisdictions compete with one another in terms of their natural attributes (climate, geographical properties, location, etc.) that are not subject to wilful change, and in terms of attributes that are subject to political choice, such as infrastructure (roads, education, and so on) or institutional framework conditions (legal security, economic constitution, and so on). Since the citizens are the principals or 'owners' of democratic jurisdictions, one may say that they, represented by their governments, compete for mobile resources that they would like to attract to, and retain in, their respective jurisdictions. The interests that citizens assert in this context may very well be in conflict, not only among persons but also intra-personally, since citizens can be affected in different capacities by the impact of competition among jurisdictions: as inhabitants of a jurisdiction, as suppliers of labour and human capital, as holders of mobile financial capital or of less mobile invested capital, as consumers, or in other respects.

The willingness of jurisdiction-users to remain, and to use their mobile resources, in a jurisdiction will depend on what may be called their jurisdiction rent, i.e. the difference between the return they get from investing their resources in a given jurisdiction and the return that they could realise by changing to the most attractive alternative jurisdiction open to them. Since the most favourable alternative return represents the opportunity costs of the investment of resources in any given jurisdiction, by implication the jurisdiction rent is positive as long as the opportunity costs are less than the return earned in that jurisdiction, and they are negative if the opportunity costs exceed this return. If the jurisdiction rent is nil, a jurisdiction user will be indifferent between remaining in the given jurisdiction or moving his mobile resources to the most attractive alternative jurisdiction. If the jurisdiction rent is negative, he will withdraw the resources in question from the jurisdiction.

The effects of the changes that the term globalisation describes can, in terms of the above terminology, also be rephrased to suggest that a greater range and easier access of attractive alternative jurisdictions have generally increased the opportunity costs of the use of mobile resources in any specific jurisdiction. Even if, over a period of time, the 'absolute' attractiveness of a jurisdiction should not have changed at all, the jurisdiction rents may be reduced by the mere fact that new attractive alternatives have become accessible, with the effect of increasing jurisdiction-users' opportunity costs of remaining in the jurisdiction. This, of course, is even more the case if its politically modifiable attributes have become less attractive in absolute terms to mobile resources.

COMPETITION AMONG JURISDICTIONS AND COMMON INTERESTS

Competition always imposes restrictions on the competitors. In this sense, as already noted, competition among jurisdiction imposes, quite obviously, restrictions on governments which make it costly or even impossible for them to implement or sustain certain policies or regulations. If one supposes a substantive *a priori* list of activities that democratic governments have to pursue, one may quite easily arrive at the conclusion that competition among jurisdictions impedes governments from fulfilling some or all items on such a predefined 'democratic agenda'. If, instead, one adopts a procedural understanding of democracy, as implied in the criterion of citizen sovereignty described above, one cannot arrive at any judgement without looking more closely at the issue of what kinds of policies can be expected to be encouraged or discouraged by competition among jurisdictions. In other words, one needs to examine whether the fact citizens and jurisdictions-users may take advantage of the opportunities offered by competition among jurisdictions can, indeed, be said to prevent governments from serving common interests of their citizens.

The argument that competition among jurisdictions is in conflict with common interests of citizens, ultimately implies the claim that such competition creates a (prisoners') dilemma for the citizens involved, be it an intra-jurisdictional or an inter-jurisdictional (prisoners') dilemma, or both. In other words, to assert that a systematic conflict exists between competition among jurisdictions and democracy would mean making one or the other (or both) of the following claims: that the citizens of a jurisdiction, through their individual and separate use of the options offered to them by competition among jurisdictions, collectively put themselves in a situation which is less attractive for all than the situation they would be in if these options were not available; or that the citizens of various jurisdictions inflict mutual damage and create a situation undesirable for all, either by using separately, as individual persons, the options offered by competition among jurisdiction or by adapting separately, as a single constituency or jurisdiction, to the conditions imposed by the competition among jurisdictions.

The first case would involve an intra-jurisdictional, the second an inter-jurisdictional (prisoners') dilemma.

In the case of an intra-jurisdictional (prisoners') dilemma, competition among jurisdictions could be said to offer the citizens of a jurisdiction 'perverse' incentives which would cause them, in the pursuit of their separate individual interests, to choose strategies that, in their aggregate effects, result in collective self-damage. An example might be if citizens, acting on individual, separate profit motives, favour capital investment abroad

instead of at home, causing negative aggregate effects on living conditions in their home jurisdictions that, in their own assessment, outweigh the extra gains derived from such foreign – as opposed to domestic – investments.

In the case of an inter-jurisdictional (prisoners') dilemma, competition among jurisdictions would offer the respective citizenries, or their governments, 'perverse' incentives in the sense of causing them to make decision which, in the separate calculations of each individual jurisdiction seem advantageous, but which in their overall effect are disadvantageous for all involved.[14]

In what follows I want to examine more closely what potential reasons there might be to believe that such dilemmas exist.

CONSUMER INTERESTS, PRODUCER INTERESTS AND CITIZENS' INTERESTS

With respect to the possible reasons for (prisoners') dilemmas caused by competition among jurisdictions, it is useful to distinguish between various interests, in which the citizens of a state might be affected by competition among jurisdictions. In this respect, one can separate their interests as consumers from interests they have as producers, be it as investors, employees, or in some other capacity, and from these two kinds of interests one may, in turn, distinguish interests they may hold as 'citizens' in a more narrow sense, namely interests in jurisdiction characteristics, which they cherish as citizens of jurisdictions, separate from their capacity as consumers or producers. In terms of this distinction, the argument that competition among jurisdictions creates intra- or inter-national (prisoners') dilemmas can be restated as follows: by using – be it as consumers, as producers, or as owners of mobile resources – the options available under competition among jurisdictions, citizens, in separate and individually rational pursuit of their interests, generate overall outcomes that damage their common interests as citizens, to an extent that outweighs, in their own assessment, the benefits gained from the use of these options.

In order to locate more precisely the common citizen interests which could potentially be obstructed by competition among jurisdictions, it may be useful to start from the standard free-trade argument and its implied criterion of consumer sovereignty.[15] According to Adam Smith's classical argument, the expansion and globalisation of markets should clearly be welcomed as a source of welfare gains. By widening the extent of the market, that is by enlarging the set of exchange opportunities, it promotes division of labour and specialisation, thereby enhancing the productivity of labour as the principal source of increases in wealth: goods and services can

be made available at lower costs than otherwise would be the case. Competition among jurisdictions results precisely because the economic options created by globalisation provide benefits to those who, either as consumers and buyers or as holders of mobile resources, have an incentive to use them. To be sure, this does not imply that the immediate effects of such competition must be of unanimous advantage for all citizens or members of a jurisdiction, since those who lose customers or trading partners due to the attractiveness of such options will consider themselves disadvantaged in comparison to the status quo.[16] And since as a rule, each citizen does not experience the effects of competition among jurisdictions *solely* as a consumer, or as a holder of mobile resources, or as a producer, but embodies all or some of these interests, the various effects must be weighed up against one another when it comes to judging the overall impact of competition among jurisdictions.

The normative principle of consumer sovereignty would surely be an extremely questionable ideal if it was about dogmatically giving priority to consumer interests without considering other potential human interests that extend beyond the consumer role. If its implied constitutional recommendation, i.e. to organise the economy so that consumer preferences are the ultimate controlling variable of the process of production, is to make sense, it cannot be meant to ignore the fact that individuals are involved in the economic process as producers too, be it as investors, as entrepreneurs or as employees, and must be expected to have corresponding producer interests as well.[17] In its ultimate rationale the principle of consumer sovereignty entails the claim that, as a regulating ideal for the economic process, it is in the common interest of all citizens – and indeed, with regard to their various interests, not only as consumers or investors, but also as producers. More precisely, the principle must ultimately be interpreted as the conjecture that an economic constitution based on consumer interests exhibits more desirable working properties for all citizens, with all their diverse interests, than an economic constitution that responds to their protectionist producer interests (Vanberg, 1997a). This conjecture derives from the diagnosis that the interests in competitive openness, which people have as consumers or buyers, are consensual interests, not, however, the protectionist interests that they hold as producers.

Whatever special category of goods or services the primary interest of particular groups of buyers may aim at, openness to competition as a general principle is compatible with all such interests. In this sense, we can say that openness to competition is in the unanimous interest of consumers, as well as in the unanimous interest of producers, as far as they are affected in their role as buyers. To be sure, as mentioned before, in their role as suppliers, producers may well be negatively affected by competition among

jurisdictions, and may, therefore, be inclined to seek protectionist legislation, which would impede their customers' access to more attractive alternatives. In contrast to consumer or buyer interests in openness to competition, such protectionist producer interests are not, however, in mutual agreement. They offer no basis for a consensual economic constitution, but are in fact interests in privileges in the sense that the protectionist legislation is not sought for all producers equally but only for specific (narrowly defined) branches or industries.[18] Benefits are only to be had from protection granted to one's own specialty, not from protection granted to others. In fact, protection granted to others may well directly conflict with one's own interests, especially if granted to those whose goods or services one is in need of. Clearly, the most attractive situation is to enjoy sole protection while all others are subjected to competition. The greater the group of 'beneficiaries' of protectionist legislation, the more unfavourable the balance between the benefits derived from one's own protectionist privilege, and the disadvantageous effects of the protection granted to others. In other words, while it is attractive to be the beneficiary of protectionist regulations, if one were presented with the choice between a thoroughly protectionist system and a totally non-protectionist, competitive regime, there would be every reason to choose the latter.[19]

Another way of describing the matter is to say that citizens are faced with a (prisoners') dilemma when it comes to their protectionist producer interests. Their dominant strategy is to seek protection for their own respective economic activity. In doing so, however, they tend to bring about a situation of endemic protectionism, which is less desirable for all than a completely non-protectionist arrangement. In the normal political process, they are not confronted by the choice between a thoroughly protectionist system and a system open to competition, but by the choice to seek, or to refrain from seeking, protectionist privileges for themselves. As a rule, they have no reason to assume that their own unilateral willingness to refrain from privilege seeking will decide whether they will live under the one or the other system. Accordingly, as much as they may prefer to live in an open competitive system, this preference by itself cannot provide any motivation for unilateral restraint.

The protectionism dilemma resulting from this structure of incentives has been diagnosed as a major problem of the political process by both the Freiburg School of Law and Economics (Vanberg, 1998) and the Public Choice School.[20] A possible solution to this dilemma could be constitutional provisions which impose suitable constraints on governments and legislators; in the past, though, constitutional constraints that were meant to serve that purpose have provided only a limited remedy.[21] Competition among jurisdictions might prove to be an effective force to support the in

itself apparently somewhat limited disciplinary power of constitutional constraints.

As far as the relationship between consumer and producer interests is concerned, it is safe to say that competition among jurisdictions does not create a prisoners' dilemma, but is in fact suited to overcome an intra-jurisdictional prisoners' dilemma, namely the noted protectionism dilemma. By providing exit opportunities it restricts the power of governments to burden citizens (and jurisdiction users) with the costs of protection privileges granted to others. The overall effects of such competition can be beneficial even for those whom it deprives of their privileges, if, by overcoming the protectionism dilemma, it leads to a simultaneous abolition of all – or at least, a sufficiently large portion of all – protection privileges and thereby, to a more desirable 'game' for everybody involved. In this regard, competition among jurisdictions clearly appears to enhance rather than to impede democracy.

To be sure, all this does not yet answer the question raised earlier: whether competition among jurisdictions creates a dilemma with respect to the relationship between consumer and/or producer interests on the one hand, and citizen interests on the other. It could very well be that, besides the interests in protectionist privileges, something resembling 'general protectionist interests' exists, for instance in the sense that the citizens of a jurisdiction have shared 'protectionist' interests, distinct from the discussed producer interests in maintaining certain jurisdiction characteristics, which they feel are threatened by the forces of competition. By contrast to interests in protectionist privileges, with such 'general protectionist interests' it is conceivable that the citizens of a jurisdiction would be better off if they restricted their freedom to avail of certain options created by competition among jurisdictions.

It is undeniable that, as J. Kincaid (1992) puts it, a conflict can arise between consumership and citizenship.[22] Yet, the mere insinuation that such a dilemma might arise is insufficient justification for the claim that competition among jurisdictions poses a threat to democracy, and that, therefore, restrictions on, or elimination of, such competition is advised. In order to arrive at such a conclusion, one would need to show specifically which common interests of citizens might be enhanced by restrictions on competition, and for which regulatory restrictions on competition we can actually expect the advantages to outweigh the potential disadvantages. Even if a restriction of competition among jurisdictions may respond to certain citizen interests, this does not imply that implementing it is in fact desirable for citizens, when all its effects are considered. For instance, one might well argue that the majority of people do seem to share, quite apart from any interests in protectionist privileges, a general interest in the

stability of social and economic conditions in their own environment. The traditional and widespread resentments against competitive systems have probably fed this desire to some degree, right up to the present-day communitarian criticism of liberal society. Yet the undeniable fact that human beings hold such kinds of interests by no means implies that they seek to realise them at any cost, or that they are prepared to pay the price they would have to pay for living in a system which would consistently accommodate such interests. The past and current choices revealed in the actual behaviour of people seem to provide clear evidence to the contrary. For most of them sacrificing the advantages to be enjoyed under open competitive systems appear to be too high a price for the consistent fulfilment of their interests in stability. After all, communities such as the Amish in Pennsylvania that are thoroughly committed to traditional lifestyles, are famous just because of their rarity.

Yet, however one may interpret the available evidence, the ultimate test for the 'willingness to pay' must be seen in the willingness of people – faced with viable alternatives – to opt for such systems and remain loyal to them in the presence of exit possibilities.[23] If this is so, systems which would satisfy their citizens' common interests in stability by introducing appropriate 'protectionist constraints', should be sustainable in a world in which competition among jurisdictions prevails at least to the extent that people can exercise free choice between alternative systems. This suggests that, if we wish to improve people's chances of being able to live in systems which serve, to the largest extent possible, their common and compatible interests, including potential 'general protectionist interests', we should favour 'meta-constitutions for constitutional choice' that enhance individuals' possibilities of voluntarily choosing, individually and separately, among alternative regimes.[24] This issue, to which the theory of fiscal federalism has made important contributions,[25] is of obvious relevance in the evaluation of the effects of competition among jurisdictions on democracy.[26]

THE 'RACE TO THE BOTTOM' ARGUMENT

To the extent that problematic effects attributed to competition among jurisdictions can be traced back to intra-national (or intra-jurisdictional) dilemmas, the respective problems can be solved by unilateral, national (or jurisdictional) measures. This means that the real problem is not due to competition *per se*, but to deficiencies of the existing 'jurisdiction constitution': deficiencies which are exposed by, but not caused by competition. Admittedly, this result is of limited significance only, since the authors who stress the dangers of competition among jurisdictions seem to identify the

critical problem less in the occurrence of intra-jurisdictional (prisoners') dilemmas than in the fact that it may lead to inter-jurisdictional dilemmas. If we accept the above concept of states or jurisdictions as territorial enterprises, the supposition of such dilemmas implies the claim that competition forces governments to respond to the interests of mobile resources in ways that prevent them from maintaining regulations or taking measures that would be in the common interests of their respective constituencies. In other words, it implies that competition for mobile factors causes the competing jurisdictions – or the respective governments – to adopt measures that in their overall effect are disadvantageous for all citizens involved. A suspicion voices in this context that, as far as regulation of economic activities or taxation of enterprises is concerned, competition will result in a 'race to the bottom' to the detriment of all involved. Or fears are expressed that the provision of certain public goods and in particular, distributional policies will become impossible (Sinn, 1997a; 1997b).

As far as the issue of public goods is concerned, one needs to clarify first whether the advantages that are at stake solely benefit the citizens of the providing jurisdiction, or appreciably 'radiate beyond' the jurisdiction's boundaries. If the latter is the case, i.e. if there are significant external effects, the attractiveness of the 'free-rider option' may well prevent governments from supplying such public goods under competitive conditions, even if this would be in the common interest of all their citizens. Yet, the root of the difficulty is not, once again, to be found in competition *per se*, but in the externality problem. This problem should be resolved, however, through appropriate international (inter-jurisdictional) agreements on rules directly addressing the externality issue, rather than by eliminating competition.

The 'race to the bottom' argument is controversial mainly where state measures, regulations or services are concerned, whose alleged advantages mainly benefit the citizens of the jurisdiction concerned (Sinn, 1997a). As regards possible negative effects of competition among jurisdictions on such regulations or services, the sceptics do not always distinguish clearly enough between the issues of 'free-riding' on the one hand and 'exit' on the other. A sharp distinction has to be drawn, however, between a) problems caused when mobile resources are allowed to profit from the services or characteristics of jurisdictions, without paying an appropriate price (problems of free-riding in the provision of public goods) and b) problems that result from the fact that mobile resources have the option of migrating from less attractive regimes to more attractive jurisdictions.

The free-rider problem would in fact prevent the provision of jurisdiction characteristics which, for the citizens and jurisdiction users, have the character of public goods, as long as the option of non-contributory consumption exists. If mobile resources have the option of using the service

and infrastructure of a jurisdiction without payment, they are likely to take advantage. However, it is not competition among jurisdictions that creates this option. Competition among jurisdictions is about the migration of mobile resources from one jurisdiction to another, and migration is something completely different from free-riding. It is about choice among alternative jurisdictions with their various combinations of services and required contributions. To be sure, by migrating from one jurisdiction to another, mobile resources can avoid required contributions at the exit-jurisdiction, but they can do so only by simultaneously foregoing the services of that jurisdiction. There is no evidence that, regardless of possible differences in the quality of the services provided, they will always favour the jurisdiction that demands the lowest taxes. In fact, it is far more likely that they will seek the most attractive cost–benefit package.

A 'race to the bottom' in tax competition is not likely, as long as the applied taxation rules prohibit free-riding – i.e. the non-contributory use of jurisdiction services – and the taxes imposed on enterprises correspond to their use of jurisdiction services.[27] Where this is not guaranteed, competition among jurisdictions may well lead to a 'race to the bottom', but then the real problem is not with competition *per se*, but with deficiencies of the taxation system. Solving this problem is, however, primarily a matter of introducing appropriate reforms of taxation rules at the national level. Ruinous competition can be prevented, if international taxation competition takes the form of *Leistungswettbewerb* or 'performance competition', that is, if national taxation systems burden jurisdiction users to the extent in which they use jurisdiction services or characteristics. Should international regulations or agreements be in conflict with such a 'taxation according to benefit', there is obviously a need for reform at this level. If, say, international tax agreements grant enterprises the option of deciding whether to pay taxes in a jurisdiction whose services they actually use, or in a jurisdiction in which, figuratively speaking, they merely have a PO box, a 'race to the bottom' will be hard to avoid in enterprise taxation. But again, in such cases the problem is not with competition among jurisdictions, but with the inadequacy of the pertinent rules of the game.

To the extent that location characteristics or services provided by a jurisdiction have the properties of 'local' public goods, in the sense that the citizens and jurisdiction users are the main beneficiaries, competition among jurisdictions apparently does not stand in the way of 'taxation according to benefit'. If, as Sinn appears to do, one sees in the restriction to 'benefit taxes' an undesirable limitation of the power of government,[28] one ought to explicate on what grounds one considers it desirable and legitimate for governments to be allowed to burden citizens or jurisdiction-users with the costs of schemes from which they derive no advantage whatsoever.

In his reflections on 'A New Principle of Just Taxation' (Wicksell, 1896; 1967), Knut Wicksell more than one hundred years ago stated an argument still relevant today, on why the principle of 'taxation according to benefit' (1967) can be said to be a just principle. As he argued: 'It would seem to be a blatant injustice if someone should be forced to contribute toward the costs of some activity which does not further his interests or may even be diametrically opposed to them'.[29] Competition among jurisdictions favours the principle of 'taxation according to benefit': it offers protection against what Wicksell saw as 'the controversial part of fiscal policy' (Söderström, 1986), namely the possibility '(for) various groups to obtain advantages at the cost of others'. Of course, it may also stand in the way of projects that are not motivated by an interest in privileges, but by well-intentioned concerns for the 'general good', to the extent that the ideas proposed by the advocates of such schemes do not coincide with the assessment of the citizens and jurisdiction-users themselves. As Dennis Mueller (1998) puts it: 'Most objections to tax competition between governments on the grounds that it will lead to "social dumping" and "a race to the bottom" rest on an elitist view of government similar to that underlying the "merit want" argument. The "impartial observer" knows what the proper level of taxation for the country should be and how this money should be spent, and fears that any loss in tax revenue will harm these programmes. Such fears are unfounded, if government provide the goods and services their citizens want, and use benefit taxes to finance them.'[30]

The principle of 'taxation according to benefit' does not require a perfect proportionality between tax contributions and benefits received. It means that tax contributions are to be viewed as a price willingly payed for jurisdiction benefits which, in the judgement of the citizens or jurisdiction-users offset the costs, in the light of available options. Competition among jurisdictions in the sense of the availability of alternatives is essential for any meaningful weighing-up of costs and benefits.[31] Tax contributions which compensate for benefits to be gained in a jurisdiction are paid willingly. Competition among jurisdictions cannot jeopardise such kinds of tax systems.[32]

COMPETITION AMONG JURISDICTIONS AND REDISTRIBUTION

Under the noted conditions of 'Leistungswettbewerb' or 'performance competition' governments can only tax mobile factors if these are willing to pay the required tax as a price for the benefits they hope to reap from the use of the particular jurisdiction. Apparently, a main reason for authors like Sinn

to view a limitation to 'benefit taxes' as an undesirable restriction of political power is the suspicion 'that mobile factors cannot be taxed for redistributive purposes' (Sinn, 1994).[33] If this argument were merely meant to assert that competition among jurisdictions obstructs certain predefined redistribution aims, that are justified by reasons unrelated to 'citizen sovereignty', there is no need to discuss it in the present context. Suffice it to refer to the above comments on the incompatibility between a procedural concept of democracy and postulated state aims. The argument is of systematic interest in the present context only if it is meant as the claim that competition among jurisdictions endangers redistribution projects that serve the common interest of all citizens.[34]

Where redistributive taxes are used to produce jurisdiction characteristics (such as the 'social peace', regularly invoked in the German debate) that make the jurisdiction more attractive for citizens and jurisdiction-users, such taxes can be seen as a price that may be demanded of mobile factors no less than of citizens for permission to take advantage of these particular jurisdiction characteristics. To the extent that the option of 'free-riding' is excluded, mobile factors will be faced with the choice of paying the price demanded or foregoing the benefits of that jurisdiction. There are conceivable reasons why redistributive taxes could benefit all citizens of a jurisdiction, including those who have to pay them (Mueller, 1998). There are also conceivable reasons why the same may be true for non-citizens as jurisdiction users. Where redistributive taxes are not offset by any jurisdiction services or characteristics that offer benefits to mobile factors, the latter will obviously attempt to avoid such payments.[35] But on what grounds should a government then be allowed to recruit mobile factors for the financing of transfers, which generate no benefits for them whatsoever? If redistribution results in desirable jurisdiction characteristics, should not the beneficiaries of these characteristics also carry the costs? No doubt, the citizens of any particular jurisdiction may find attractive the prospect of having jurisdiction-users contribute to schemes that exclusively benefit them, the citizens. This, however, does not mean at all that the citizens of a single jurisdiction could realise common benefits from unilateral attempts to coerce jurisdiction-users into making such contributions, nor does it imply that the citizens of several jurisdictions, such as the citizens of EU member states, could jointly better their situation, if, in pursuit of such 'exploitative interests', they restricted jurisdictional competition among themselves. In fact, in regard to the fiscal exploitation of jurisdiction-users, the citizens of different jurisdictions are facing a 'dilemma', but it is a 'dilemma' that serves their common interests. It prevents them from adopting (exploitative) strategies, which, from the standpoint of each individual jurisdiction may seem attractive, but which would make them collectively worse off than they are by mutually refraining from employing them.

It is one question whether competition among jurisdictions prevents governments from taxing mobile factors or jurisdiction-users for redistributive purposes which would bring them no equivalent benefits. It is another question whether competition among jurisdictions prevents citizens from implementing redistribution schemes among themselves, which could be of benefit to all. That this is the case is argued by Sinn, who focuses on redistribution as a form of insurance:[36] 'Redistribution and insurance are two sides of the same coin, their difference lies primarily in the point of time at which they are evaluated. *Ex post*, every insurance contract involves redistribution. *Ex ante*, before the dice of destiny are cast, much of the foreseen redistribution can be seen as insurance against the risk of income variations' (Sinn, 1997b).[37] Such an interpretation of redistribution as an insurance scheme in the common interest of all citizens no doubt makes sense. It does not dispense, however, with the question as to whether the existing redistribution arrangements actually pass the test that has to be passed by any 'efficient' insurance scheme, namely that it is *ex ante* beneficial for all parties, and thus gives all parties *ex ante* good reasons willingly to participate in the arrangement. Nor does it dispense with the necessity to examine why insurance schemes that pass this test should be threatened by competition among jurisdictions.

If, in this light, we look at one of the main elements of the redistributive machinery of the welfare state, namely the subsidisation of 'threatened' industries, as an 'insurance against the risk of income variations' (Sinn, 1997b), it seems very doubtful that this particular element qualifies as an *ex ante* beneficial insurance scheme for all citizens. This kind of insurance against market risks can only be granted as a privilege to selected groups. It clearly is not practicable as a general rule equally applicable to all. However understandable the desire for such a safeguard against market risks may be, it cannot be satisfied in a manner still desirable if extended to all parties in a non-discriminatory manner. As Hayek once put it:

> That anyone should suffer a great diminution of his income . . . undoubtedly offends our sense of justice. The demands of those who suffer in this way, for state interference on their behalf . . ., are certain to receive popular sympathy and support. The general approval of these demands has had the effect that governments everywhere have taken action . . . to shelter them from the vicissitudes of the market. Certainty of a given income can, however, not be given to all . . . and if it is provided for some, it becomes a privilege at the expense of others whose security is thereby necessarily diminished (Hayek, 1944).[38]

On the other hand, the fact that an arrangement granting the 'privilege of security' only to some can scarcely be regarded as an insurance beneficial for all, by no means implies that the interest in social safeguards could not

be accounted for in a manner that would, indeed, benefit all.[39] A redistributive regime that can genuinely claim to serve the interests of all citizens, however, would have to pass the minimal test, namely that it is capable of extending equal treatment to all parties involved in a non-discriminating, privilege-free manner.[40] Even if redistribution schemes that grant privileges to some at the expense of others can, indeed, hardly be sustained under conditions of competition among jurisdictions, there is no reason why privilege-free schemes for social insurance could not be organised in ways that enable them to be viable under such conditions.

However, in his concern about the anti-redistribution effects of competition among jurisdictions, Sinn focuses not on the above aspects of the 'redistributional state' but on transgenerational 'insurance aspects' of the welfare state, specifically the possibility created by the 'redistributional state', to obtain, not only for oneself but also for future descendants, insurance against 'life risks' such as, in particular, reductions in one's earning potential due to disability, illness, or accident.[41] Such transgenerational insurance schemes, for which, according to Sinn, there are no substitutes in the private law arena,[42] are, Sinn claims, *ex ante* beneficial for all,[43] but cannot be sustained under conditions of competition among jurisdictions. The reason, he says, is that under the conditions of such competition, the basic requirement of an efficient insurance cannot be guaranteed, namely that insurees who have not suffered damages cannot *ex post* evade liability to pay.[44] With respect to the situation in the European Community, Sinn (1994) states: 'Even such beneficial redistribution would not be able to survive in a Europe where the single countries compete with one another. A Europe with free migration is like an insurance where the customers can choose the company *ex post*.'

If we assume for a moment that competition among jurisdictions actually does jeopardise the welfare state in its present form,[45] and leave aside the question whether there are, indeed, no private law substitutes conceivable that could serve the kind of insurance interests which Sinn has in mind, his argument raises two fundamental questions: the first question is whether the 'breakdown of national redistribution schemes under institutional competition' (Sinn, 1994), which he fears, can justifiably be blamed on competition, or whether instead, it manifests functional deficiencies of the existing redistributive machinery of the welfare state. In other words, the question is whether an adequate response to the difficulties faced by the welfare state lies in restricting competition among jurisdictions, a measure which Sinn appears to favour,[46] or whether instead it lies in appropriate reforms of existing welfare institutions themselves – reforms that would enable these institutions to survive under competitive conditions. The second question is: if the transgenerational insurance scheme that Sinn has

in mind should actually turn out not to be viable under competitive conditions, are the restrictions on competition – and thereby on individuals' freedom of choice – that are necessary to make the scheme viable not perhaps associated with disadvantages that outweigh the advantages of the hoped-for insurance protection?

As regards the first question, Sinn himself concedes that if existing welfare regulations run into difficulties, it may not least be due to internal structural deficiencies, and he even points out possibilities for appropriate reforms, such as the adoption of a 'homeland principle in taxation'.[47] As regards the second question, it is not entirely clear from Sinn's argument how we should, in the case of the insurance scheme in question, separate problems of free-riding from problems due to the insufficient attractiveness of the scheme. Needless to say, no insurance can be viable if 'free-riding', claiming services without sharing the costs, is not excluded. Preventing free-riding is, however, something entirely different from preventing exit from, or forcing participation in, an insurance scheme. The free-rider seeks to enjoy benefits without payment. By contrast, if someone wants to exit, or refuses to join, he simply reveals that he considers the balance of advantages and disadvantages unfavourable. It is difficult to see what other ultimate test should exist to the claim that a redistributional regime provides insurance beneficial to all parties, if not the willingness to join and remain within the scheme, in the presence of potential alternatives. If the exclusion of the exit option is declared a precondition for the welfare state's insurance arrangements to be viable, it is difficult to see how the claim of the advantageousness of such an arrangement for all involved can be put to the test. Yet, Sinn's argument does, indeed, seem to take such a turn by his failure to clearly distinguish between problems of exit and those of free-riding,[48] a failure that appears to due to his particular notion of the transgenerational nature of such 'welfare insurance'.

Sinn (1997a) is surely right when he states that an insurance contract can only produce its beneficial effect if it is signed before the risks are played out and is faithfully executed afterwards. This is, unquestionably, also true for any viable welfare-state insurance arrangement. Yet an arrangement of this kind must, undoubtedly, also be subjected to the test of being *ex ante* advantageous for all parties and of being, accordingly, able to count on voluntary participation. Considering Sinn's understanding of the requirements of a transgenerational welfare-state insurance, the question has to be asked who are to be the 'sovereigns' whose voluntary consent is to count as the relevant test of the preferability of this insurance?[49] To be sure, Sinn (1997a) rightly argues that it is a matter of *ex ante* versus *ex post* perspective whether a redistributive scheme can be viewed as an insurance.[50] If, however, future generations and those who have not yet come of age are to

be included in the insurance, does this mean that the appropriate *ex ante* perspective can only be applied by the first 'founder generation', that only their assessment of costs and benefits is to count, and that all subsequent generations are de-franchised in this respect? If the 'playing out of the risks' includes the strong or weak talents with which people are born, what does it mean to say that it cannot be permitted to allow those who know they have been lucky to opt out of the system (Sinn, 1997a)?[51] Does it ultimately mean that implementing the intended insurance arrangement requires eliminating the right to exit from the polity?[52]

There are presumably good reasons why, as Sinn notes (with some regret?),[53] our legal system does not allow for private contracts binding one's personal offspring in the manner envisaged by his insurance scheme. The fact that the political process allows such commitments to be made and enforced, at least to a certain degree, does not mean that the reasons for abstinence under private law have no significance at this level. It certainly does not mean that the restrictions necessary for their enforcement may not entail disadvantages for the parties involved, which outweigh the anticipated benefits, whether these restrictions mean that the option to withdraw is taken away directly through an 'exit ban', or indirectly, through 'international harmonisation'. Giving up one's own exit right would no doubt be a considerable price, if a person had to pay it for the welfare state's protection of his life risks. The sacrifice of this right in the name of subsequent generations would not only be an even higher price, it would conflict with the fundamental principles of legitimacy of a democratic polity, which has to continually prove that it is, in the eyes of its current citizens, serving the common interests of all.

There is no doubt that individuals feel a need to insure themselves and their offspring against what Sinn terms 'life risks', and there is no doubt that the state as an organisation may also serve as a vehicle to cater for this need in a way beneficial to all. The benefit of such arrangements should, however, be demonstrated by the very fact that they are capable of securing the loyalty of their clientele, in the face of potential alternatives. In this regard, competition among jurisdictions can not only generate incentives for 'insurers' to be responsive to the needs of their 'clients', it can also serve an important function for insurers and insurees as a process of discovery, helping them to find out how the insurance needs in question can be satisfied most effectively and economically. Before taking the severe step of accepting the restrictions of freedom entailed in the restrictions of competition among jurisdictions proposed by Sinn, one ought to check if competition-compatible solutions do not already exist for welfare-state matters.[54]

COMPETITION AMONG JURISDICTIONS AND RULES OF COMPETITION

To the extent that the problems diagnosed as consequences of competition among jurisdictions are to do with shortcomings in national regulations – which are merely exposed by, but not caused by, competition among jurisdictions – adequate remedies are to be found in corrections of the respective national constitutional deficiencies, not in the restriction of competition. This applies, for instance, wherever alleged problems of competition among jurisdictions can be traced to inadequate provisions against free-riding at the national level, and can, consequently, be eliminated by taking adequate precautions. Problems of this kind can be remedied through unilateral national measures, without any need for international coordination. Many of the symptoms generally deplored as problems of competition among jurisdictions can be shown to fall into this category.

Problems of competition among jurisdictions which can be traced back to intra-national constitutional deficiencies can be remedied by national constitutional reforms. This is different with problems that may be described as 'genuine problems of competition' in the sense that they result from deficiencies in the 'rules of competition', i.e. in the 'rules of the game' according to which competition exists. Such 'genuine problems of competition' cannot be effectively remedied through unilateral national measures but only through international constitutional agreements. As with all competition, competition among jurisdictions always takes place under some 'rules of the game', ranging from the 'everything goes' of genuine anarchy to a perfect 'harmonisation' across jurisdictions that eliminates almost any competition. And as with all competition, the working properties of competition among jurisdictions depends on the nature of these 'rules of the game' (Vanberg, 1995).

Choosing rules of competition among jurisdictions means to choose rules of the game that apply to the inclusive constituency, i.e. to the citizenries of all participating jurisdictions. In a sense, a more inclusive jurisdiction is created, defined by the mutual recognition and implementation of the respective rules of the game. The appropriate criterion for the desirability of these rules is, accordingly, the common interests of all citizens within the inclusive jurisdiction. In other words, according to the democratic principle of citizen sovereignty the desirability of reforms in the rules for competition among jurisdictions should be measured by whether they generate benefits for all citizens involved, in comparison with the existing rules of competition.

An example of a type of competition among jurisdictions where adopting better rules of the game may, indeed, serve the common interests of all

those involved, is the competition for mobile factors through the granting of special privileges in the form of subsidies, tax benefits or other preferential treatment, which are granted in a discretionary and discriminating manner to selected persons or groups, but not to others. Just as the citizens of any single jurisdiction become domestically embroiled in a rent-seeking dilemma under a regime of privilege-granting, and can all benefit from constitutional provision that effectively restricts the ability of the government and legislature to grant privileges, the citizens of several jurisdictions find themselves in an inter-jurisdictional rent-seeking dilemma if their governments conduct the competition for mobile factors through the granting of privileges, and they can all benefit from effectively restricting the possibilities of privilege-granting through appropriate rules of competition.[55]

Clearly, one option in the agreement on rules for competition among jurisdictions would be for the jurisdictions involved to harmonise contested regulations, thereby eliminating competition among themselves with regard to the respective provisions. An example would be setting standard rates of taxation for enterprises or standard forms of welfare state provisions (Sinn, 1997a). However, before one jumps from diagnosing undesirable effects of competition among jurisdictions to recommending harmonisation, one should examine whether the diagnosed negative effects cannot be averted by subjecting competition to more appropriate rules of the game instead of eliminating it altogether.[56] The relevant alternatives are clearly not exhausted by 'unbridled tax competition'[57] or 'unbridled competitive confrontation' (Sinn, 1994) on the one hand and harmonisation on the other.[58] Without having explored the possibility of competition under *appropriate rules* more carefully, it would certainly be premature to recommend centralistic reforms as a remedy against deficiencies of competition among jurisdictions. This should be kept in mind when, in reference to the European situation, Sinn (1994) advocates 'centralised actions' as a fairly sure strategy to prevent inefficiencies in institutional competition, while dismissing the option of improving the rules of competition: an alternative, but at this stage, highly speculative, remedy would be the search for a constitutional framework under which government competition can be expected to work.[59]

CONCLUSION

The theme of this chapter has been the relationship between democratic political processes and competition among jurisdictions. If we look at democratic polities as cooperatives or joint enterprises for the common benefit of their citizens, and if we measure the performance of democratic

systems against the criterion of citizen sovereignty, then we must examine the effects of competition among jurisdictions with respect to the two key tasks that democratic constitutions have to accomplish: first of all, to enable governments to implement measures that do in fact reflect the common interests of all citizens, and secondly, to prevent governments from carrying out projects that conflict with the interests of some or all of its citizens.

As far as the second task is concerned, the arguments discussed in this chapter clearly imply that competition among jurisdictions can make a valuable contribution to 'the improvement of democracy' by making it more difficult for governments to implement political schemes that benefit some citizens at the expense of others. To the extent of their own mobility and the mobility of their resources, competition among jurisdictions offers citizens and jurisdiction-users effective protection against exploitation, be it in favour of privileged groups or of those who hold the reins of political decisionmaking power.

As regards the ability of governments to act in the common interests of all citizens, competition among jurisdictions can be expected to assist governments and citizens, in its role as a discovery procedure, in solving the by no means trivial problem of ascertaining precisely which jurisdiction characteristics and services best serve the common interests of citizens, and how these jurisdiction characteristics and services can be provided most efficiently. In this respect too, competition among jurisdictions can help to improve democracy. On the other hand, as my discussion of the resentment against competition among jurisdictions was meant to show, there are no obvious indications that this competition would impede or prevent governments from implementing schemes that can truly be claimed to benefit all citizens. If, in this respect, detrimental effects of competition appear to exist, one should first examine whether such effects can actually be blamed on competition itself, or whether they are instead a result of constitutional deficiencies at the national or the international level. Constitutional deficiencies at the national level can arise from the failure to prevent problems of free-riding, due to incentives for mobile resources to extract benefits from jurisdiction services without paying for them. Free-rider problems of this kind should be strictly distinguished from the issue that is at the heart of competition of jurisdictions, namely mobility and exit, an issue concerned with whether mobile factors are ready to pay the price demanded for jurisdiction services, or prefer to forego these services in favour of alternative options. Constitutional deficiencies at the international level can be due to the failure to frame competition among jurisdictions by appropriate rules of the game. Until the possibilities for eliminating constitutional deficiencies at this level are explored, it is inappropriate to recommend centralistic solutions.

NOTES

1. Chapter presented as a paper at the 1999 Annual Meeting of the European Public Choice Society, Lisbon, 7–10 April.
2. This chapter is based on a paper originally written in German. A first translation draft was prepared by Linda O'Riordan at the Institute for Advanced Study in Berlin. I am grateful to her as well as to the Institute for its support of this project.
3. Sinn (1994: 96) speaks of the 'ability of taxed goods and factors to migrate across the borders and the constraints on government behaviour imposed thereby'. Sinn (1997b: 248): 'Countries will compete for mobile factors of production and tax bases and face strong pressures to reform their fiscal and regulatory systems.'
4. The term 'jurisdiction-users' refers to persons who, be it as citizens or as non-citizens, allocate mobile resources in a jurisdiction, in the form of financial capital, investment capital, human capital or other.
5. Sinn (1997b: 248): 'Since governments have stepped in where markets have failed, it can hardly be expected that a reintroduction of a market through the backdoor of systems competition will work. It is likely to bring about the same kind of market failure that justified government intervention in the first place.'
6. One of the most articulated proponents of this argument is B.R. Barber (1996).
7. In his *A Theory of Justice*, John Rawls characterises a democratic society 'as a cooperative venture for mutual advantage' (1971: 84). The idea that the democratic state is an enterprise for the common gain of all citizens was the basic leitidea of Knut Wicksell's work 'A new principle of just taxation' (Wicksell, 1896: 76–164; 1967), in which he speaks out against the fiscal principle of 'taxation according to the ability-to-pay', and for the principle of 'taxation according to benefit' (ibid.: 74). This principle should, so he says, assure 'that taxes . . . would come to be regarded as what they really should be, namely as means to procure for the community as a whole and for each of its classes particular benefits which could not be obtained in other ways'. Söderström (1986: 94) defines Wicksell's approach as follows: 'According to Wicksell, the government should be a beneficial organ for all its subjects. This cannot be the case unless the interests of all persons are fully respected when fiscal policy is determined . . . otherwise taxation is a tool for theft and waste.' Wicksell maintained, so Söderström claims (ibid.: 91), 'that the interests of everyone should be respected. This, he thought, would be most favourable for all parties in the long run.' Wagner (1988: 163) comments: 'Wicksell's theoretical interest was to articulate general constitutional principles to which government must adhere if it is meaningfully to reflect the consent of the governed.' Wicksell's work was known to be the inspiration for James Buchanan's draft of a 'constitutional political economy' (Buchanan, 1990).
8. Decision-making costs, strategic behaviour and other reasons might prevent decisions from finding unanimous approval even if, indeed, they would serve the common interests of all involved.
9. In the language of game metaphors, this can be expressed as follows: the issue is not that every individual *toy* benefits all involved, but that the *game* (i.e. the system of rules) is more advantageous for all than potential alternative games or systems of rules. With regard to Knut Wicksell's theories on the role of unanimity as a fiscal principle of legitimation, Wagner (1988: 160) notes: 'In assessing the practical nature of Wicksell's work, it is essential to distinguish between a general principle of consensual governance and specific methods or institutional formats through which such a principle might be implemented.' On the question of unanimity, Wicksell (1967: 90) wrote: 'In the final analysis, unanimity and fully voluntary consent in the making of decisions prove the only certain and palpable guarantee against injustice in tax distribution. The whole discussion on tax justice remains suspended in mid-air so long as these conditions are not satisfied at least approximately.'
10. J.S. Mill (1977: 435 ff.) refers to the two problems of democratic constitutions addressed here, in his work 'Considerations on Representative Government', when he writes:

'The defect of any form of government may be either negative or positive. It is negatively defective if it does not concentrate in the hands of the authorities power sufficient to fulfil the necessary offices of a government. . . . The *positive* evils and dangers of the representative, as of every form of government, may be reduced to two heads; first, . . . insufficient mental qualifications in the controlling body; secondly, the danger of its being under the influence of interests not identical with the general welfare of the community.'

11. The significance of the knowledge problem and the role of competition among jurisdictions as a 'discovery procedure' (Hayek) is discussed by Kerber (1998: 200f.).
12. The significance of the competitive dynamics in federal systems for generating knowledge on how governments can serve the interests of their citizens better is noted by Hayek (1944: 235; 1948: 255–69; 1960: 184f., 263f.).
13. Sinn (1994: 98) says that 'a tax on a mobile factor of production cannot survive in a process of institutional competition. Only taxes on the immobile factors of production will be chosen'.
14. The existence of such an *inter*-jurisdictional dilemma is alleged, for instance, by Sinn (1997a: 39) and Scharpf (1998: 47).
15. For a detailed discussion see R. Sally (1998, in particular pp. 35 ff.).
16. Hayek (1976: 121) notes on this issue: 'Any discovery of more favourable opportunities for satisfying their needs by some will thus be a disadvantage to those on whose services they would otherwise have relied. . . . Of course, those who as a result will be deprived of their former customers will incur a loss which it would be in their interest to prevent.'
17. In reference to the negative effects of competition on those who lose their former customers and transaction partners to more attractive alternatives (Hayek, 1976: 120), Hayek (ibid.: 121) asks the rhetorical question: 'Does this mean that something is disregarded that ought to be taken into account in the formation of a desirable order?' His answer is that these disadvantages are outweighed for everybody involved by the benefits provided by an order, 'the advantage of which is that it continually adapts the use of resources to conditions unforeseen and unknown to most people. . . . The effects of new and more favourable opportunities for exchanging which appear for particular individuals are for society as a whole as beneficial as the discovery of new or hitherto unknown material resources' (ibid.: 121f.). He adds: 'And though in the short run the unfavourable effects may out-balance the sum of the indirect beneficial effects, in the long run the sum of all those particular effects . . . are likely to improve the chances of all' (ibid.: 122).
18. The term 'privileges' is used here for regulations that 'secure benefits to some at the expense of others, in a manner which cannot be justified *by principles capable of general application*' (Hayek, 1976: 129).
19. In this sense, mutually accepting a binding rule prohibiting any granting of protectionist privileges should be in the interest of all. As Hayek (1976: 122) notes on this issue: 'it should be obvious that we will achieve the best results if we abide by a rule which, if consistently applied, is likely to increase everybody's chances.' See also Buchanan (1989).
20. Hayek (1976: 122) notes on this issue: 'The known and concentrated harm to those who lose part or all of the customary source of income must . . . not be allowed to count against the diffused . . . benefits to many. We shall see that the universal tendency of politics is to give preferential consideration to a few strong and therefore conspicuous effects over the numerous small and therefore neglected ones, and therefore to grant special privileges to groups threatened with the loss of positions they have achieved.'
21. On the constitutional ideal of liberalism Hayek (1944: *ix* f.) notes: 'The essence of the liberal position, however, is the denial of all privilege, if privilege is understood in its proper and original meaning of the state granting and protecting rights to some which are not available on equal terms to others.'
22. On this see Vanberg (1997b).
23. It was one of the core arguments of Tiebout's (1956) classical contribution to the theory of fiscal federalism that competition among jurisdictions not only induces local governments to be responsive to citizens' preferences, but also requires citizens to reveal their 'willingness to pay' and their 'true preferences for public goods'.

24. R. Nozick's (1974: 297ff.) discussion on a 'framework for Utopia' centres around the idea of a 'meta-constitution' that allows individuals to choose freely among communities which, in turn, are free to agree, internally, on all kinds of restrictions, as long as freedom of mobility is maintained. Under such conditions, communities are subject to the test of voluntary participation: 'Each community must win and hold the voluntary adherence of its members' (ibid.: 316).
25. At the beginning of the chapter on 'The prospects of international order' in *The Road to Serfdom* Hayek (1944: 219) cites Lord Acton with the following quotation: 'Of all checks on democracy, federation has been the most efficacious and the most congenial. . . . It is the only method of curbing not only the majority but the power of the whole people.' Hayek comments: 'Nineteenth-century liberals may not have been fully aware *how* essential a complement of their principles a federal organisation of the different states formed' (ibid.: 234f.).
26. J. Kincaid (1991: 98) notes on what he calls the principle of 'federal democracy': 'At base, a federal democracy is a voluntary association of persons and jurisdictions. The right of persons to emigrate is fundamental. However, because emigration is costly, citizens must have effective choices within the polity. Here, competition performs a dual function. It allows citizens to migrate from one group or jurisdiction to another in search of satisfaction, and it encourages public and private institutions to satisfy their constituents so that they stay put voluntarily.'
27. To organize a tax system so as to accomplish this is, quite obviously, not an easy task. But here, as in other areas, competition may serve a useful function as a 'discovery procedure' allowing governments and citizens to find out which schemes are more efficient in solving this problem than others. On this issue see C.B. Blankart (1997; 1999).
28. Sinn (1994: 98f.): 'Competition will drive the tax rate on a mobile factor down to . . . a mere benefit charge, . . . no redistributive taxation is possible.' Sinn adds (ibid.: 101): 'In the end, all countries will settle at an equilibrium where only benefit taxes are charged, and no redistribution policies are carried out.'
29. On the relevance of the Wicksellian concept for the issue of competiton among jurisdictions see also Mueller (1998: 180f.). Wicksell was an advocate of what R.A. Musgrave has termed 'voluntary exchange theory of public economy', a theory which Musgrave thought to be of no practical relevance (Wagner l988: 162).
30. Mueller (1998: 186) adds: 'Citizens in the United States move into communities with high quality police forces, *not away* from them, and they are willing to pay the high property taxes that are needed to finance these high quality public services. They do move away from cities with high tax rates and *low* quality schools and other public services, however, like Washington, DC.'
31. Hayek (1978: 162) notes on the working properties of federal competition: 'The regional and local governments . . . would develop into business-like coprorations competing with each other for citizens who could vote with their feet for that corporation which offered them the highest benefits compared with the price charged.'
32. In reference to environmental regulation J.D. Wilson (1996: 394) notes on this issue: 'A critical condition for efficiency is that each firm pays a tax equal to the costs that its operations impose on the jurisdictions. These costs can consist of the costs incurred in providing public goods and services to the firms plus environmental costs. Given that governments are able to use taxes as "user fees" in this manner, considerations involving capital mobility do not enter into the benefit–cost rules governments use to choose environmental standards.'
33. In reference to the competition among jurisdictions induced by the 'four basic liberties' within the EU, Sinn (1994: 101) suspects: 'Eventually, not only redistributive taxes have to be lifted to the community level when the four liberties are to be granted, to some extent even benefit taxes for local public goods must be too.'
34. Sinn (1994: 99): 'Redistribution policy can potentially be interpreted as an efficiency enhancing activity of the state.'
35. Mueller (1998: 179): 'Just as diners are unlikely to frequent a restaurant that continually overcharges them, if they have other options, a citizen who is overtaxed for the goods

and services she receives seeks to avoid these taxes. In an increasingly mobile world, . . . communities are forced to rely on benefit taxation and to limit activities to those public goods and services that benefit all members of the community. In the limit, mobility acts like a silent unanimity rule and produces the same outcomes as we would expect under this voting rule in an immobile world.'

36. Sinn (1997b: 258): 'Redistribution can have many reasons including charity, social and political stabilisation, or ethics and justice. Arguably the most important reason is the insurance it provides in an uncertain world.'
37. Sinn (1994: 99): 'Contracts that ex ante can be interpreted as insurance, involve redistribution from an ex post perspective, and what we call redistribution can often be seen as insurance from an ex ante perspective. Redistribution can therefore be a useful government activity that generates benefits similar to those provided by the insurance industry.'
38. See also Hayek (1944: 128ff.). In another context Hayek (1967: 173) notes on this issue: 'More than by anything else the market order has been distorted by efforts to protect groups from a decline from their former position. . . . In a market order the fact that a group of persons has achieved a certain relative position cannot give them a claim in justice to maintain it, because this cannot be defended by a rule which could be equally applied to all.'
39. On this issue Hayek (1944: 132) notes: 'There can be no question that adequate security against severe privation . . . will have to be one of the main goals of policy.'
40. That a discretionary politics that grants subsidies to particular groups may well produce more severe inequalities than those inherent in the distribution of earning powers in the market has been pointed out by M. Olson (1982: 175): 'There is greater inequality . . . in the opportunity to create distributional coalitions than there is in the inherent productive abilities of people.'
41. Sinn (1997b: 259): 'Consider the preferences of parents or parents to be. At or before the time of birth the parents do not know whether their child will be handicapped or healthy, gifted or untalented. They are therefore interested in obtaining insurance against the lifetime income variations resulting from these differences.'
42. Sinn (1997b: 259): 'The market cannot provide this insurance since this would imply that the parents sign a bondage contract for their children from which these children could not escape even if they wished to do so. . . . There is little doubt that private markets cannot provide the type of career insurance which is the essence of income redistribution through the government budget.'
43. Sinn (1997b: 259): 'Redistribution through the government budget can be seen as insurance against being a bad risk and as such it may be welcomed by all citizens before destiny has lifted its veil of ignorance.'
44. Sinn (1997b: 262) comments on the 'implications of fiscal competition among redistributive tax systems': 'Suppose the country's borders are opened and both capital and labour can freely migrate across them. This liberty . . . will affect insurance through redistributive taxation since the government loses its power to enforce the payment of taxes.'
45. On the need to qualify this supposition see, for instance, Windisch (1999: 166f.); Feld et al. (1997); Straubhaar (1998: 261 ff).
46. In reference to the fact that competition among jurisdictions favours 'benefit taxes' and does not allow for 'redistributive taxation', Sinn (1994: 99) notes: 'To avoid this implication, the tax rates have to be harmonised across all countries or chosen by a centralised agency.'
47. See Sinn (1997a: 49; 1998). On the issue of competition-compatible welfare-state provisions see also Kerber (1998: 214 ff.).
48. Sinn (1994: 99): 'Even such beneficial redistribution would not be able to survive in a Europe where the single countries compete with one another. A Europe with free migration is like an insurance where the customers can choose the company ex post.'
49. If, as Sinn (1997b: 264) argues, 'a private solution is infeasible because private redistribution contracts cannot be written early enough', the question has to be asked: what is 'early enough' in the context of a 'political solution', given the fact that a political community consists of a continuous stream of overlapping generations?

50. Sinn (1997b: 259): 'Arguably, the main reason why the government can do better than private insurance markets is that it can introduce its insurance protection earlier, before the "good risks" and the "bad risks" have been sorted out.'
51. What are the implications if the functioning of a redistributive arrangement requires 'that the parents sign a bondage contract for their children from which these children could not escape even if they wished to do so' (Sinn, 1997b: 259)? Is *one* parent-generation entitled to commit all future generations?
52. What is implied, one has to ask, when Sinn (1997b: 264) argues: 'In a closed economy, the government can remedy the situation because it can provide insurance through the tax law. It has the power to enforce the necessary resource transfer between the lucky and the unlucky without having to rely on voluntary private contracts. In an open economy, however, this power vanishes with the right to migrate across the borders. The good risks leave the insurance state just as they would leave the insurance company.'
53. Sinn (1997b: 259): 'Whether the absence of bondage is a market failure or the result of a government intervention that requires another intervention to patch up the consequences can be left open here.'
54. The issue of how redistribution-insurance may be organised in a competition-compatible manner is also briefly addressed by Sinn (1994: 100; 1997a: 49).
55. The perversities of such competition by granting privileges are instructively illustrated by D.I. Barlett and J.B. Steele (1988) in their documentation on 'Corporate welfare'.
56. The general issue of appropriate 'rules for competition among jurisdictions' is discussed by W. Kerber (1998).
57. Sinn (1997b: 263): 'The welfare state has no survival chance when unbridled tax competition is allowed.'
58. On the problems with harmonisation Mueller (1998: 187) comments: 'The most attractive response for many European governments will be to reduce the options of its citizens by pressing for tax and regulation harmonisation, and thereby avoid the politically costly steps of having to take away the subsidies and privileges to which the politically most powerful groups have become accustomed. . . . Although uniform taxes on capital would stop the movement of capital from high tax countries like Germany into low tax countries like Ireland, they would not deter the flow of capital *outside* the EU, indeed they would stimulate it. . . . The danger Europe faces, if it responds to the pressure from increasing mobility and globalisation by tax harmonisation, is that it retains its system of high redistributive taxes and regulations, preserves the resulting inefficiencies, and becomes therefore an increasingly unattractive place for businesses to locate, people to work, and eventually for people to live.'
59. A more sceptical view is voiced, however, in Sinn (1997a: 48).

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PART III

Empirical Evidence

5. Globalisation: contradictory implications for US women

Cal Clark and Janet Clark

INTRODUCTION

Over the last decade or so, 'globalisation' has become so widely used that it may well have been transformed from a scholarly 'concept' to a popular 'buzzword'. Moreover, both the scholarly and popular discussion of globalisation appear schizophrenic. For some, globalisation suggests that the new millennium (the twenty-first century) will actually live up to its name, with greater prosperity in many nations, leading to less hierarchic relations in the business world, the spread of democracy in an historic 'third wave', and far fewer threats to world peace in the so-called 'global village'. Conversely, others view globalisation as the primary driving force behind alarmingly regressive change. In particular, they cite the growing inequality and social turmoil in the developed world, the exploitation of developing nations and the subversion of indigenous cultures and values by 'Coca-Cola capitalism', all stemming from the decreased ability of governments to protect the public interest from corporate policy (Clark, 2001). These 'schizophrenic scenarios' result from the fact that globalisation has brought profound economic change throughout the world which has created many 'winners' and 'losers' both among and within societies.

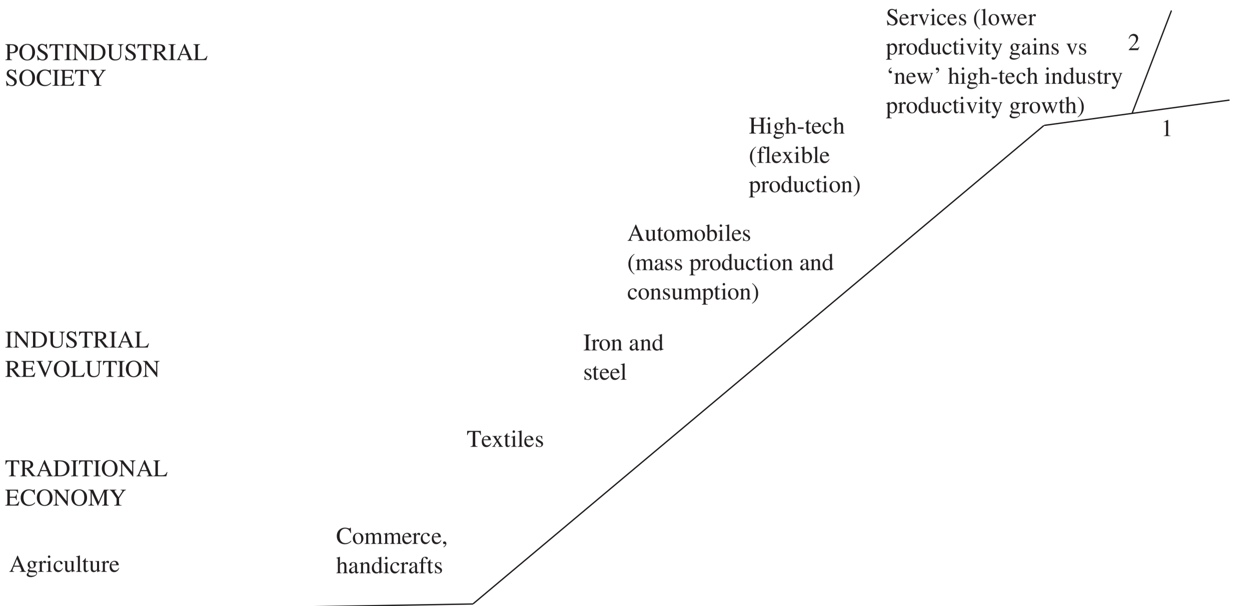
In particular, the developed world is undergoing a transformation from 'Industrial Age' to 'Information Age' societies, while industrialisation is spreading to many more parts of the developing world. For the last two centuries, industrialisation has been the hallmark of the most developed societies. The nature of industrialisation itself, though, has changed dramatically over the nineteenth and twentieth centuries in terms of which industry was the most advanced or its 'technological driver' – first textiles, then iron and steel, then automobiles and most recently high-tech and advanced electronics.

Figure 5.1 sketches an overview of how these changes in leading industry constitute an 'S-curve' in terms of increases in productivity and GNP – the curve in Figure 5.1 is viewed (at least by economists) as looking like

an S. In traditional agricultural economies, productivity increases are of necessity relatively small, but productivity and consequently GNP growth 'take off' (Rostow, 1960) once industrialisation starts. The first big jump is into light industry (for example, textiles and shoes); and heavy industry creates another surge in productivity. Conventionally, it was assumed that the growth of the tertiary or service economy that succeeds heavy industry in this model would result in decelerating productivity gains and economic growth; and growth in the advanced industrial societies did indeed slow noticeably once they reached a 'mature' level of development, as indicated by line 1 in Figure 5.1 (Kuznets, 1976; Rostow, 1960). However, the recent surge in the high-tech and information industries has led to the argument that these new technologies have generated a new upswing in productivity and growth (denoted by line 2 in Figure 5.1) that has been labelled the 'new economy' (Atkinson et al., 2000; Friedman, 1999; Thurow, 1999).

During the postwar era and especially over the last two decades, 'globalisation' has increased the speed at which domestic economies are transformed from one stage to another along the S-curve in Figure 5.1. In essence, globalisation refers to the growing economic interdependence (i.e. trade and capital flows and the activities of multinational corporations) across national borders that has marked the late twentieth century. Such interdependence, in turn, is the result of the transportation and communications revolutions of the second half of the century that made it possible to ship goods, funds and information around the world cheaply and quickly, coupled with the declining national barriers to such economic flows that resulted from US pressures over the postwar era for an open *laissez faire* global economy. The increasing trade and capital flows associated with globalisation, in turn, have facilitated the spread of industrialisation to new areas, thereby creating continuous pressure for economic upgrading throughout the world (Gilpin, 1987; Greider, 1997; Thurow, 1992, 1996).

Globalisation, however, has been a two-edged sword in regard to its impact on the United States (similarly to other nations) as the new technologies that are driving it both undercut the nation's position in traditional industries and create the foundation for a new economic surge in the high-tech and advanced services sectors. This replacement of America's Industrial Age economy by an Information Age one brings to mind Joseph Schumpeter's (1950) critical insight that economic development is a process of 'creative destruction'. On the one hand, the emergence of the 'new economy' represents extremely good news for America. There is 'life after manufacturing'; and the very strong performance of the US economy for most of the 1990s demonstrates the vitality and growth of these new industries. Still, there most certainly is an 'on the other hand' since the



Note: Line signifies rate of annual GNP and productivity growth. Line 1 represents conventional theory; line 2 represents the theory of the 'new economy'.

Figure 5.1 Changes in leading economic activity and the 'S-curve' of productivity and GNP growth

'destructive' half of creative destruction is far too great to be ignored either. Many workers and communities that prospered in the industrial age have proved incapable of adjusting to the 'new economy', creating increasing social and economic inequality for a significant segment of the population (Greider, 1997; Harrison and Bluestone, 1988; Thurow, 1996). In particular, the 'new economy' is putting an increasing premium upon education for determining an individual's life chances and upon the human capital base for determining a community's economic prospects (Malecki, 1997; Salamon, 1991; Smith, 1995; Thurow, 1996, 1999).

This chapter, hence, seeks to tease out the contradictory implications that globalisation has had for the role and status of women in the United States. In particular, it asks how America's transformation to an Information Age society and economy is affecting the status of women in the USA: what are the benefits and burdens of socioeconomic change for women? Are some groups and kinds of women affected differently than others? What long-term implications do these changes have for women in the United States? The first section of the chapter describes the social and economic position of women; and the second considers women's changing role in the political process. Finally, we briefly consider what globalisation may portend for women as the twenty-first century unfolds.

THE IMPLICATIONS OF GLOBALISATION FOR THE SOCIOECONOMIC STATUS OF WOMEN IN THE UNITED STATES

A priori, the economic changes that result from globalisation have mixed implications for women. The transformation of the US economy from one based on 'physical labour' to one based on 'mental labour' should, in abstract theory, be favourable for women. However, women can only take advantage of the opportunities provided by the 'new economy' if they have broad access to the relevant education and if they do not face major discrimination when they enter the labour market. These conditions are by no means assured. This section, therefore, seeks to evaluate women's position in the United States by examining how women fare in three links of the presumed chain of causality determining their roles and status in an American society that is being increasingly shaped by the 'new economy' of the Information Age. First, how good, relative to men, is the access that women have to the educational system? Second, how do women and men compare in their participation in the labour force and in their ability to get 'good jobs'? Finally, how equal are social outcomes for women and men in the United States?

GROWING GENDER EQUALITY IN EDUCATION

The data in Table 5.1 indicate that educational opportunities have expanded tremendously in the United States during the last half century of the postwar era and that, at least in the aggregate sense, women's access to education differs little from men's. In 1950, only about a third of Americans were high-school graduates. Over the next 50 years, this proportion rose steadily to nearly 85 per cent, as a high-school education became nearly universal and as generational replacement substituted more educated for less educated people. Throughout this time, the high-school graduation rates of women and men remained almost exactly the same. The opportunity for a college education also expanded greatly, but here the pattern for the two genders diverged fairly sharply. As the postwar era commenced, only a small social and economic élite had graduated from college, with men being only slightly more likely to have done so than women (7 per cent to 5 per cent). Access to higher education increased greatly over the next two decades, but men were the primary beneficiaries of these new opportunities. For example, the increase in the population with college degrees between 1950 and 1970 was over twice as much for men (seven percentage points from 7 per cent to 14 per cent) than for women (three percentage points from 5 per cent to 8 per cent). After 1970, women's graduation rates began to approach and, by the 1990s, surpass those of men, but because of men's advantage in the 1950s and 1960s, the absolute difference between men and women in possessing a college degree has decreased only slightly. Consequently, women and men under 45 have almost equal graduation rates of about 27 per cent, although the difference between the sexes quickly increases by age for those who are older (*American Men and Women*, 2000).

Of course, the fact that women are gaining equal access to higher education in general does not guarantee a substantive equality if, for example, women students are concentrated in less desirable fields. Table 5.2,

Table 5.1 Graduation rates of the US population by gender

Year	High-school graduates		College graduates	
	Men	Women	Men	Women
1950	33%	36%	7%	5%
1970	55%	55%	14%	8%
1985	74%	74%	23%	16%
1998	83%	83%	27%	22%

Source: *American Men and Women: Demographics of the Sexes*, 2000, p. 63.

Table 5.2 Women's share of college degrees

	1975/76	1995/96
All undergraduates	46%	55%
Health professions	79%	81%
Education	73%	75%
Psychology	55%	73%
English	62%	66%
Visual and performing arts	61%	59%
Biological and life sciences	35%	53%
Business	20%	49%
Social sciences	38%	48%
Mathematics	40%	46%
Physical sciences	19%	36%
Computer science	20%	28%
Engineering	3%	16%
All professional degrees		42%
Law		44%
Medicine		41%

Sources: *American Men and Women: Demographics of the Sexes*, 2000, p. 103; Costello and Stone, 2001, p. 203.

therefore, examines women's share of the degrees awarded in specific fields in the mid-1970s and the mid-1990s. This table contains generally good news, although there are several less desirable aspects as well. First, women's representation in higher education increased significantly during these two decades from 46 per cent to 55 per cent of all undergraduate degrees, suggesting that women have been putting themselves into a position to take advantage of the expanding (at least until the recession of 2001) 'new economy' in the United States. The data on individual degrees are a little more mixed, though. None of the five fields that women dominate (health professions, education, psychology, English and the visual and performing arts) are particularly associated with 'good jobs' for those with bachelor's degrees. Yet, the figures are more positive for the more desirable fields of the biological sciences, business and mathematics, in which women received approximately half the degrees in 1996; and, likewise, women received a respectable 40–45 per cent of the advanced degrees in law and medicine. Finally, while women remain substantially underrepresented in the physical sciences, computer science and engineering, they have made substantial gains over the two decades covered by these data. Thus, even taking the more detailed data on degree fields into account, the conclusion

seems inescapable that women have made very considerable progress toward educational equality in postwar America.

WOMEN IN THE WORK FORCE: SIGNIFICANT GAINS BUT STILL A SIGNIFICANT LAG BEHIND MEN'S ACCOMPLISHMENTS

We analysed women's access to education, particularly higher education, in the United States because equality in education is assumed to be necessary for women to benefit from the opportunities available in the 'new economy'. Whether women have been able to take advantage of their educational accomplishments is another and an open question, though. That is, equal education is a necessary but not a sufficient condition for women's attainment of economic equality. When we consider the data on women in the work force in this section, in fact, we find that women have made significant progress over the last few decades toward economic equality, similar to the situation in education. However, the progress has been markedly less than in the sphere of education, leaving open the question of whether 'the glass is half full or half empty'.

Particularly during the early part of the postwar boom in the United States, men were much more likely to hold jobs in the formal economy than women, at least in part because women in many families were able to stay home as housewives. For example, Table 5.3 shows that in 1950 only 34 per cent of women, as compared to 81 per cent of men, were in the labour force, resulting in a labour force that was 70 per cent male and 30 per cent female. Over the next 40 years, women's rate of participation in the labour force increased steadily to 43 per cent in 1979 and 58 per cent in 1990 before levelling off at about 60 per cent for the last decade or so. In contrast, men's participation rate fell slightly due to the growing share of retirees in the population. Thus, women constituted approximately 45 per cent of the work force during the 1990s, although this somewhat overstates their role in the economy since a quarter of women but only a tenth of men work part-time.

Women, then, have greatly increased their role in the formal economy over the postwar era. This says very little about their socioeconomic status, however. For example, the unemployed wife of a business executive has high status, while a 'shop girl' or a 'sales girl' does not. Consequently, it is necessary to examine the occupational distribution of women and men in Table 5.4 to get much sense of how women's broad-scale entrance into the work force over the second half of the twentieth century has affected their socioeconomic status. The top two occupational categories are clearly

Table 5.3 Participation in the labour force by gender

	1950	1970	1980	1990	1997
Men's rate of participation in the labour force	81%	80%	77%	76%	75%*
Women's rate of participation in the labour force	34%	43%	52%	58%	60%*
Married women's rate of participation in the labour force		39%	50%	58%	62%
Women's share of labour force	30%	38%	43%	45%	46%

Note: *In 1997, 90 per cent of the men and 75 per cent of the women in the labour force were full-time.

Sources: *American Men and Women: Demographics of the Sexes*, 2000, pp. 241 and 248; Costello and Stone, 2001, pp. 184 and 228.

Table 5.4 Occupational distribution by gender

	Women		Men	
	1988	1998	1988	1998
Managerial and professional	25%	31%	26%	28%
Managerial	11%	14%	14%	15%
Professional	14%	17%	12%	13%
Technical, sales and administrative support	45%	41%	20%	20%
Service occupations	18%	18%	10%	10%
Skilled labour	2%	2%	20%	19%
Blue collar	9%	7%	21%	20%
Agriculture	1%	1%	5%	4%
Total	100%	100%	102%*	101%*

Note: *Do not sum to 100 per cent because of rounding errors.

Source: Costello and Stone, 2001, p. 245.

managerial and professional. Here, women do surprisingly well. In 1988, about a quarter of both women and men held these types of jobs; and over the next decade, there actually was a slightly greater growth in women's share (25 per cent to 31 per cent) than in men's (26 per cent to 28 per cent), suggesting that women may indeed have been benefiting from the economic changes brought on by globalisation. The position of women *vis-à-vis* men is, as might be expected, slightly better among professionals than among managers. Still, these data certainly indicate that women seem quite competitive in the 'knowledge jobs' associated with America's 'new economy'.

In contrast to managerial and professional jobs, Table 5.4 also shows that there is considerable sex segregation in other parts of the labour force. Women are twice as likely as men to hold technical, sales and administrative support jobs and to work in service occupations. Men are almost three times as likely to hold 'blue collar' manufacturing jobs and compose 90 per cent of the skilled labour pool. These data contain both good and bad news for women. In static terms, skilled labour and those manufacturing jobs that are unionised generally command much higher wages than the sectors in which women predominate. However, with manufacturing in America increasingly being forced to move off shore, the dynamic change brought about by globalisation appears quite favourable to women.

Women's broad-scale entrance into managerial and professional occupations, of course, does not necessarily mean that they have attained equal power to men within these traditionally male occupations. In fact, their low representation in the top positions has generally been taken to indicate a 'glass ceiling' that limits their career options and mobility in most businesses. For example, women are represented in management in approximately the same proportion that they constitute of the total business workforce in the United States (40 per cent). Yet, they hold only slightly over a tenth of the positions of corporate officers or directors in Fortune 500 companies (i.e., the largest businesses in the USA) and only 5 per cent or less of the very top positions in these companies (Wellington and Giscombe, 2001).

Overall, the lagging but improving position of women in the American economy is well illustrated by the data on comparative average wage rates in Table 5.5. In 1970, women workers were clearly at a gross disadvantage compared to their male colleagues since among full-time employees the median income of women was only 59 per cent of men's. Over the next 30 years, the position of women improved dramatically, but they still remained far short of receiving equal pay. While the real wages of men stagnated at about \$36 250 in constant 1998 dollars (reflecting the decline of Industrial Age sectors), women's real wages jumped by a quarter from \$21 470 to \$26 855, raising women's median salaries to 74 per cent of men's (83 per cent

Table 5.5 Median income of full-time workers by gender

	Women	Men	Ratio of Women to Men
1970	$21 470	$36 247	59%
1985	$24 620	$37 870	65%
1998	$26 855	$36 252	74%*

Note: *83 per cent in the 25–34 age category.

Sources: *American Men and Women: Demographics of the Sexes*, 2000, p. 189; Costello and Stone, 2001, p. 267.

for those in the 25–34 age category). These gains resulted from two interacting trends. First, women are able to compete much more equally with men in an Information Age, as opposed to an Industrial Age, economy; second, changing legal and social norms have made open wage discrimination much harder. Still, the 'gender gap' in earnings remains pronounced; and the fact that it is little affected by such factors as education and occupation (*American Men and Women*, 2000) certainly indicates that women still faced significant discrimination as the twenty-first century opened.

WOMEN'S SOMEWHAT LAGGING POSITION IN SOCIAL OUTCOMES IN THE UNITED STATES

As the adage 'the proof of the pudding is in the eating' implies, women's progress in education and the job market, desirable as they are for their own sake, are most important because they could potentially serve as the basis for attaining equality between the sexes in the socioeconomic outcomes that occur in American society. In the 1970s, for example, there was a growing perception that the 'feminisation of poverty' was becoming a significant social problem (Erie and Rein, 1988; Goldberg and Kremen, 1990). When most Americans married fairly young, as they did at the beginning of the postwar era, wealth and poverty were generally shared fairly equally by women and men. Several social trends in the 1960s began to change this situation, though. The marriage age rose significantly; the number of 'nontraditional families' rose dramatically; and probably most importantly, the divorce rate jumped two-and-a-half fold between 1960 and 1980 (Costello and Stone, 2001). Since divorce, on average, proves financially beneficial for men and financially disadvantageous for women, the combined impact of these trends was to make women much more vulnerable in terms of their personal finances.

Table 5.6 Poverty rates by gender

Year	Poverty rate for women	Poverty rate for men	Women's share of poor
1970	14.0%	11.1%	57%
1975	13.8%	10.7%	58%
1980	14.7%	11.2%	58%
1985	15.6%	12.3%	57%
1990	15.2%	11.7%	58%
1993	16.9%	13.3%	57%
1998	14.3%	11.1%	57%

Source: *American Men and Women: Demographics of the Sexes*, 2000, p. 229.

The data on the official poverty rate in the United States that are presented in Table 5.6 confirm that the image of the 'feminisation of poverty' is true to a significant extent. For the last three decades, the poverty rate for women (which has varied between 14 per cent and 17 per cent depending upon the business cycle) has been nearly 30 per cent higher than for men. This difference between the sexes has stayed almost exactly the same, with women constituting 57–58 per cent of those living in poverty throughout this period. Thus, far more is at work than rising divorce rates and 'deadbeat dads' who refuse to honour their financial responsibilities to their old families since this difference clearly predated the peak of the divorce rate in 1980.

Even so, the social consequences of rising divorce and illegitimacy are considerable because of the financial difficulties facing single mothers. Over the last two decades of the twentieth century, families headed by single women have on average received incomes of only about one-third of those going to married couples; and, if anything, the gap between the two increased slightly over time. Since almost a quarter of America's children (23 per cent) now live in female-headed families, this huge gap may have profound implications for the future (Costello and Stone, 2001). The social problems associated with the feminisation of poverty are especially pronounced for minority women who have more limited access to education and, almost certainly, more suspicions to overcome in the job market than white women (Wellington and Giscombe, 2001). As the data in Table 5.7 show, women of colour are much less likely to have managerial and professional jobs and more likely to work in generally low-paying service occupations than white women. This also implies that the 'creative destruction' of globalisation is a two-edged sword for women (or probably almost any group). While those women with the requisite skills and personal contacts are benefiting, a significant number of women (especially minorities) who

Table 5.7 Women's occupational distribution by race, 1998

	White	Black	Hispanic
Managerial and professional	33%	23%	17%
Technical, sales and administrative support	41%	39%	37%
Service occupations	16%	25%	27%
Skilled labour	2%	2%	3%
Blue collar	7%	10%	14%
Agriculture	1%	1%	2%
Total	100%	100%	100%

Source: Costello and Stone, 2001, p. 246.

are not so skilled and connected are becoming increasingly marginalised in American society.

WOMEN IN POLITICS: A GROWING PRESENCE DESPITE GROSS UNDERREPRESENTATION

When we turn to women's ability to gain political office in the United States, the situation is quite similar to the one for top-level business executives. Women are grossly underrepresented in political leadership positions, but they made encouraging gains during the 1990s. Women's limited access to political power is becoming increasingly critical, furthermore, because women and men have developed significantly different voting patterns since 1980 in what has been called the 'gender gap' in American politics. The gender gap in voting, in turn, rests on similar differences in the political attitudes of women and men. Thus, women appear to have emerged as a distinct 'constituency' whose political interests deserve much better representation.

As indicated by the data in Table 5.8, women's access to political leadership was pitiful until very recently, as women's level of office-holding was among the lowest in the developed world. In 1979, for instance, women held just 3 per cent of the seats in the US Congress (America's national legislature) and won only one in ten of the elections for state legislatures and elected state executive and administrative positions. During the 1980s, women achieved some progress in state legislatures, in which their membership rose to 17 per cent, but their gains in Congress and in state executive positions were hardly noticeable. Women finally began to make impressive gains during the 1990s, but their level of representation still

Table 5.8 Rates of women's office-holding in the USA

	1979	1989*	1997	2001
US Congress	3%	5%	10%	14%
State legislatures	10%	17%	21%	22%
State elected officials	11%	14%	22%	28%
Governor			4%	
Lt Governor			34%	
Mayors of 100 largest cities				13%
Federal Judiciary				
Supreme Court		11%	22%	
Circuit courts		12%	19%	
District courts		10%	18%	
US Magistrates		18%	20%	

Note: *1991 for Federal Judiciary.

Sources: Center for the American Woman and Politics, 2002; Costello and Stone, 2001, p. 329.

remains quite low. The number of women in Congress almost tripled, but even now only one of seven members of Congress is a woman. Likewise, the number of women winning statewide elections and holding federal judiciary positions doubled, but they still only constitute 20–30 per cent of these positions; and their ability to win such major executive positions as governor of a state or mayor of a large city remains very low.

Furthermore, the United States continued to stand out among the industrialised democracies for its very lagging position in terms of women in national legislatures. America's 14 per cent of women in Congress in early 2002, for example, ranked 16th among the 21 developed democracies included in the Inter-Parliamentary Union's (2002) database and was only about 60 per cent of the average for the developed world. In stark contrast, half a dozen nations in Scandinavia and northern Europe have women as a third or more of their parliamentarians. Previous analysis suggests that there are several distinct reasons for women's very low level of representation in the United States. First, American Congressmen and women are elected in single-member districts, while women candidates almost inevitably do better in nations that have proportional representation based on party lists of candidates. Second, women do worse in countries that have conservative political cultures, such as America's, which are marked by weak labour unions and strong traditional religions. Finally, the strong effect of incumbency on US elections creates a major obstacle for changing

the gender ratio of elected officials very much (Darcy et al., 1994; Norris, 1985; Rule, 1987, 2000).

Unlike women's role in the economy, where the material disadvantages of inequality are most explicit, women's gross underrepresentation in the political sphere might be considered potentially more ambiguous. While equal representation is certainly desirable normatively, its practical consequences might be slight if women and men had similar political attitudes and did not diverge very much in their voting patterns (Sapiro, 1981). This indeed was the case during the first six decades that women had the right to vote in the United States, the 1920s through the 1970s (Freeman, 2000; Stoper, 1989). Beginning in 1980 when the USA moved in a markedly more conservative direction following the election of Ronald Reagan as president, however, women have voted significantly differently from men. Thus, their underrepresentation has become a much more pressing political question.

Since the 1980 presidential election, political attitudes and voting in the United States have been marked by a 'gender gap' in which women are more liberal and more supportive of the Democratic Party than men by approximately six to ten percentage points in voting in national elections. This gender gap of women being more liberal than men in voting and partisanship is a fairly recent development in American politics, as indicated by Table 5.9, which presents the gender gap in presidential and congressional voting since the early 1950s when public opinion data first became widely available. Until the late 1970s, the voting behaviour of men and women was remarkably similar. For most of this period, there was little systematic difference between the sexes. In fact, women, if anything, were more likely than men to vote for Republican Dwight Eisenhower (by 5 to 6 percentage points) in both 1952 and 1956.

During the 1980s and 1990s, in sharp contrast, women became substantially more supportive of Democrats than men in presidential voting. This gender gap emerged in 1980, when Republican Ronald Reagan won the Presidency from Democratic incumbent Jimmy Carter. For the first time (at least since public opinion data were available to show it), the Democratic presidential candidate received a significantly higher proportion of the vote from women (45 per cent) than from men (36 per cent), creating a gender gap of 9 percentage points. A gender gap of 6 percentage points also occurred in the 1980 voting for the US House of Representative as 54 per cent of women, as opposed to 48 per cent of men, cast their ballots for Democratic candidates. Since then the gender gap of women providing more support to Democrats has averaged eight percentage points in presidential elections and six percentage points in Congressional races, with the largest gaps of 11 percentage points being recorded in the 1996 and 2000 presidential and 1994 House elections. Thus, it appears reasonable to

Table 5.9 Development of the gender gap in voting and partnership

	Democratic presidential vote			Democratic house vote		
	Men	Women	Gap	Men	Women	Gap
1952	47%	42%	−5%	48%	49%	1%
1954	–	–	–	–	–	–
1956	45%	39%	−6%	58%	48%	−10%
1958	–	–	–	61%	60%	−1%
1960	52%	49%	−3%	55%	56%	1%
1962	–	–	–	61%	55%	−6%
1964	60%	62%	2%	65%	65%	0%
1966	–	–	–	62%	53%	−9%
1968	41%	45%	4%	52%	52%	0%
1970	–	–	–	54%	55%	1%
1972	36%	37%	1%	57%	56%	−1%
1974	–	–	–	63%	61%	−2%
1976	50%	50%	0%	58%	57%	−1%
1978	–	–	–	60%	58%	−2%
1980	36%	45%	9%	49%	55%	6%
1982	–	–	–	55%	58%	3%
1984	37%	44%	7%	48%	54%	6%
1986	–	–	–	51%	54%	3%
1988	41%	49%	8%	52%	57%	5%
1990	–	–	–	52%	55%	3%
1992	41%	45%	4%	52%	55%	3%
1994	–	–	–	42%	53%	11%
1996	43%	54%	11%	45%	54%	9%
1998	–	–	–	45%	51%	6%
2000	42%	53%	11%	44%	53%	9%

Sources: Center for the American Woman and Politics, 2002; *New York Times*, 1996; *Public Perspective*, 1999; Seltzer et al., 1997, pp. 34–5, 37, 41 and 131.

conclude that the 1980 campaign and elections marked a significant turning point in US electoral behaviour which resulted in the emergence of the gender gap as we know it today (Bendyna and Lake, 1994; Carroll, 1988, 1989; Chaney et al., 1998; Clark and Clark, 1996, 1999; Dolan, 1998; Kenski, 1988; Klein, 1984; Mueller, 1988; Poole and Zeigler, 1985; Sapiro and Conover, 1997; Seltzer et al., 1997; Shapiro and Mahajan, 1986; Wilcox and Jelen, 1996). In fact, the size of the gender gap is now approaching the differences in voting produced by such central factors as income, education, region and religion (Clark and Clark, 1999).

The gender gap in voting is presumed to reflect similar differences or gaps on a fairly broad array of issues, such as those regarding women's rights and status, compassion toward or empathy with the dispossessed and disadvantaged in American society, support for an activist government to ameliorate social ills, opposition to violence and (as a result of these specific issue positions) general ideological liberalism (Chaney et al., 1998; Clark and Clark, 1999, 2000; Conover, 1988; Cook and Wilcox, 1991; Gilens, 1988; Kaufman and Petrocik, 1999; Poole and Zeigler, 1985; Seltzer et al., 1997; Shapiro and Mahajan, 1986; Stoper, 1989; Tolleson-Rinehart, 1992; Trevor, 1999; Whirls, 1986).

An analysis of data from the 1996 National Election Study (NES) conducted by the University of Michigan, which is the most sophisticated compilation of public opinion data on political issues in the United States, generally confirms that these presumed differences in the political positions of women and men really do exist. For example, in terms of general ideology, women were 9 per cent more likely than men (30 per cent to 21 per cent) to consider themselves liberals, a difference that corresponds fairly closely to the gaps in voting and partisanship. Furthermore, gender gaps of six percentage points or more exist for a wide array of specific issues in all the issue areas noted above, although their absolute magnitude tends to be somewhat less than the ones for voting and partisanship (Clark and Clark, 2000). Still, taken together, these data seem to provide fairly strong support for the expectation that women and men differ significantly in their political views, even if these differences represent, to use the phrase of Seltzer and his associates (1997), 'a gap, not a chasm'.

Naturally, women would be expected to be more supportive of women's rights and women's issues than men. For example, women were significantly more likely than men to feel close to feminists (14 per cent to 6 per cent) and to have a positive view of the women's movement (71 per cent to 60 per cent). Furthermore, even where a significant difference between women and men did not exist, there is some evidence of the expected attitudes of women. Thus, the strong majorities of men who had warm feelings toward the women's movement and who supported equal rights for women in the economy and politics (as opposed to their staying at home) arguably reflect the success of the feminist movement in changing public opinion, both male and female. Thus, 'consciousness' issues clearly contribute to the gender gap in the United States.

In addition to the 'consciousness' of feminist issues, women have also been found to be more liberal because of their greater 'compassion' or empathy for others and their greater 'cost-bearing' due to the 'feminisation of poverty' (Clark et. al., 2000). Both the 'compassion' and 'cost-bearing' components of the gender gap should push women toward being more

supportive than men of an activist government which pursues redistributive policies to aid the marginal and disadvantaged members of society. Women, for instance, were considerably more likely than men to want to enhance the role of government in the United States (62 per cent to 45 per cent) and were more supportive of governmental initiatives in a broad array of social areas, with the gender gaps being the widest (averaging ten percentage points) for redistributive spending to help the poor, support for the elderly, education and opposition to cutting governmental services in order to finance a tax cut. The one exception to this pattern concerns welfare policy where women generally shared men's general disdain for the concept and past practice of public welfare in the United States.

Finally, women have long been viewed as more strongly opposed to violence than men (Chaney et al., 1998; Conover and Sapiro, 1993; Gilens, 1988; Shapiro and Mahajan, 1986; Smith, 1984; Wilcox et al., 1993); and the data for this last group of variables are quite consistent with this supposition. In terms of foreign affairs, women were ten percentage points less likely to want increased defense spending than men (30 per cent to 40 per cent) in line with data from the 1980s that attitudes on defence spending are an important component of the gender gap (Gilens, 1988). Women's greater opposition to violence is also apparent for domestic issues concerning public safety and the environment. In fact, women's much greater support for gun control than men's (57 per cent to 34 per cent) constitutes the largest gender gap on a specific issue in 1996, suggesting that this issue has become a major dividing line between women and men. Women were also considerably more supportive of environmental regulation than men (59 per cent to 46 per cent) and were somewhat more liberal by about seven percentage points on several issues concerning the criminal justice system (i.e., the death penalty and whether solving social problems or punishing criminals formed the best strategy for reducing crime).

GLOBALISATION AND THE STATUS OF WOMEN IN THE UNITED STATES: AN UNCERTAIN BALANCE SHEET

In general, the growing premium on education has helped women improve their status in the economy. Women's increased entrance into important professional occupations, in turn, provides them with more opportunities for group networking and almost certainly has contributed to the increasing number of women holding political office (although their share of political positions still remains fairly low compared to other advanced industrial societies). Moreover, globalisation and the transformation to the

Information Age are challenging and undercutting the traditional culture which supported limited and subordinate roles for women.

Not all the results of globalisation are favourable for increasing the status of women in the USA however. First, the backlash against globalisation is centered on a 'culture war' that seeks to return to traditional values, especially regarding the role of women (Conover and Gray, 1983; Sears and Huddy, 1990). Second, women who do not have access to education are perhaps more subject than men to marginalisation in the new economy; and significant numbers of women, especially among minorities, fall into this category. Finally, women's continuing role as care-givers makes them especially sensitive to the limitations of the increasingly *laissez faire* political regime, thereby explaining the growing 'gender gap' in voting that has marked US politics over the last two decades. Since the declining role of government in the United States (Kingdon, 1999) may well limit America's ability to achieve the human capital development necessary to remain competitive in the Information Age (Clark, 2001; Thurow, 1999), the position of women in this political divide now seems the one more compatible with continued prosperity for the USA in the early twenty-first century.

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6. Corruption: is dollarisation a solution?

Jennifer S. Holmes and Sheila Amin Gutiérrez de Piñeres

INTRODUCTION

Dollarisation removes the ability of governments to print money. In theory, dollarisation would limit the opportunity for politicians to use discretionary spending for bribes, private use and wasteful programmes. Under dollarisation, misuse of funds becomes more apparent because every dollar spent on illegitimate uses reduces the amount of funds available for necessary government activities and programmes. It may be easier to hide graft and corruption in countries with national currencies.

Endemic corruption hinders development.[1] Corruption redirects resources from productive uses to perpetual graft and corruption, resulting in large social welfare losses. Additionally, once corruption becomes pervasive and systemic, it becomes almost impossible to remove. Although some scholars view corruption as conducive to development,[2] corruption may undermine institutions and public confidence.[3]

Previous studies examine the development of dollarisation and the impact of dollarisation on monetary policy and seigniorage.[4] This chapter asks different questions. How can a society with pervasive corruption change its incentive structure to discourage dishonest and corrupt behaviour? In theory, dollarisation should reduce opportunities for corruption at the federal level.[5] Does dollarisation restrict the opportunity for corruption at the federal level by increasing transparency and budget discipline? What is the impact of dollarisation on federal fiscal responsibility and corruption? Despite few cases, this chapter provides an initial assessment of the effects of dollarisation.

DOLLARISATION BASICS

There are two types of dollarisation: demand side dollarisation, when citizens on their own decide to convert their wealth from their national

currency to dollars (also called currency substitution or unofficial dollarisation)[6] and supply side dollarisation, which is the official use of a foreign currency as legal tender.[7] This analysis is not concerned with demand side dollarisation, which is usually driven by market forces. Why would citizens turn to a foreign currency? When a government begins a policy of deficit spending, inflation rates rise and erode the future value of currency. In an attempt to preserve future wealth, citizens convert domestic currency into a more stable and reliable currency. In most cases, this more stable currency has been the dollar.

Studies have also shown it is difficult to de-dollarise.[8] (De-dollarisation is the conversion of foreign currency assets back into domestic currency assets.) Loss of confidence in a government's ability to manage the economy is difficult to overcome. Citizens may eventually use domestic currency for transactions, while maintaining wealth in foreign currency assets. In many cases the government will attempt to 'nationalise' bank accounts but as various authors have shown this is difficult and only a short-term solution.[9]

In supply side dollarisation all domestic currency is converted at a predetermined rate into the foreign currency. All assets and transactions are then denominated in the foreign currency. Once this occurs the government no longer prints any domestic currency and the official and legal tender of the country becomes the foreign currency of choice: in most cases, the dollar. Examples of this are Panama, dollarised since its independence in 1904, Ecuador, dollarised in 2000, East Timor and other smaller countries. An analogous example is the recent move by European countries to abandon their local currencies in favour of the Euro. In most cases, once a country begins to consider supply side dollarisation, the demand side dollarisation has already occurred. In cases of demand side dollarisation, citizens have already limited their use of national currencies, which reduces the costs of dollarisation. Most research on supply side dollarisation has focused on the path to dollarisation and the costs and benefits to a country of dollarising.[10]

What are the benefits? First, supply-side dollarisation reduces exchange rate risk and restores long-run stability to the value of the currency. In this sense, businesses can make long-range decisions and strategic plans without the fear of major currency devaluation. With the elimination of exchange rate risk, real interest rates fall. Investment increases as does the future capital stock and growth potential of the country.[11] International transaction costs are reduced when trade is conducted in one currency and intermediate conversions eliminated. Since many developing countries import a considerable amount of their intermediate inputs, dollarisation keeps the costs of these goods predictable and allows for constant production flows. For example, when a country has a major devaluation, the price of imported goods increases, creating bottlenecks in the production

process. Finally, many developing countries' debt is already denominated in foreign currency. Devaluations increase the costs of servicing that debt and put an additional burden on taxpayers. If banks have borrowed in foreign denominated loans, devaluation can make them insolvent overnight, further exacerbating the crises. According to Berg and Borensztein (2000), 'dollarisation might also strengthen institutions and boost investment'.[12] No monetary policy means no massive devaluations and less likelihood of currency crises and economic chaos.[13]

Second, dollarisation eliminates large capital outflows, resulting from unsustainable exchange rates. Large fluctuations in capital movements and portfolio investments can potentially destabilise an economy. Capital inflows 'can push a country into insolvency or drastically lower the productivity of existing capital stock, resulting in large unexpected swings in relative prices and costly bankruptcy battles'.[14] Furthermore, Calvo and Reinhart (1999) document that banking crises are protracted and contractionary. In most cases, it takes at least three years for a country to recover to pre-crises growth rates. Dollarisation creates international financial integration, which reduces the likelihood of domestic banking instability. Dollarisation makes banking crises less likely by encouraging transparency and solvency in banks as there is no longer a lender of last resort to mask their inefficiencies.

What are the costs of dollarisation? First, dollarisation leads to a loss of control of monetary policy. Monetary policy is the ability of the government to manipulate the economy through interest changes by increasing and decreasing the money supply. If the central bank increases the money supply, interest rates fall, stimulating investment and growth. The ability to print money also allows the government to deficit finance.[15] However, this advantage is problematic. High growth rates in the money supply lead to high inflation and eventually devaluation. Devaluation can lead to chaos as banks and businesses can no longer service their foreign currency denominated debt. General overall poverty increases when the value of domestic savings falls.

A second concern is the loss of seigniorage. Seigniorage is the difference between the actual cost to manufacture the money and its face value. Income from seigniorage is approximately 0.5 to 1.2 per cent of GDP.[16] An additional income source from seigniorage is the 'inflation tax'. As inflation rises, the value of money erodes. That erosion benefits the government, as citizens need more and more money to conduct transactions.[17] There is also the cost of converting infrastructure to dollars from domestic currency, which is a one-time cost, estimated to be around 0.25 to 0.5 per cent of GDP. However, most likely conversion costs would be lower because of advances in technology.

Table 6.1 Officially, unofficially and semi-officially dollarised countries as of January 2000

Officially dollarised countries	East Timor (2000), Marshall Islands (1944), Micronesia (1944), Palau (1944), Panama (1904), Turks and Caicos Islands (1973), Ecuador (2000)
Unofficially dollarised	Most of Latin America and the Caribbean, especially Argentina, Bolivia, Mexico, Peru, and Central America; most of the former Soviet Union, especially Armenia, Azerbaijan, Georgia, Russia, and Ukraine; various other countries including Mongolia, Mozambique, Romania, Turkey and Vietnam
Semi-officially dollarised	Bahamas, Cambodia, Haiti, Laos

Source: 'Basics of Dollarisation', *Staff Report of the Joint Economic Committee*, January 2000.

Third, in many countries, the central bank serves as the lender of last resort to banks. The lender of last resort exists to lend banks money when they are 'temporarily' insolvent. Again, this advantage presents risks. Central banks in developing countries may perpetrate inefficient and unsustainable banking systems. Devaluation pushes banks into insolvency, creating a need for an IMF bailout, as in the Mexican Tequila crises, the Russian Vodka crises, and in East Asia. The cost of the bailout is borne by the taxpayers and citizens of that country.

Finally, in theory, dollarisation would restrict national sovereignty, insomuch as the government loses the ability of monetary policy to manage its economy. However, in countries where dollarisation is an attractive option, the government has already lost the credibility necessary to conduct monetary policy. In effect, the government loses a tool that it has already lost. Dollarisation forces governments to be fiscally responsible and eliminates the role of monetary policy in managing the economy.

Table 6.1 lists countries that are fully dollarised, semi-dollarised and unofficially dollarised. Most of the officially dollarised countries are tiny island nations. For example, Micronesia and Palau were part of the UN Trust Territory under US administration, the Marshall Islands were formerly a US protectorate, and the Turks and Caicos Islands were a British overseas territory. East Timor is not universally recognised as an independent country. For these reasons the experience of these nations is not appropriate for generalising to other countries or economies. Panama and Ecuador are examples of independent nations choosing to dollarise.

Table 6.2 European countries: Euro and non-Euro countries as of 2003

Euro countries	Austria, Belgium, Finland, Greece, Germany, Ireland, Italy, Luxemburg, Netherlands, Portugal and Spain
Non Euro countries	Bulgaria, Albania, Armenia, Belarus, Croatia, Czech Republic, Denmark, Estonia, Finland, Hungary, Iceland, Latvia, Macedonia, Norway, Poland, Romania, Russia, Slovak Republic, Slovenia, Sweden, Switzerland, Ukraine, United Kingdom, and Yugoslavia

Table 6.2 presents a list of European countries that have and have not adopted the Euro as their national currency. Although the EU experience is significantly different in certain aspects, such as the ability of member countries to borrow from the European Central Bank, the transition to the Euro is analogous to dollarisation in the sense that countries abolish their currencies and lose control of their monetary policy.[18]

A POTENTIAL LIMITATION ON CORRUPTION

Dollarisation has the potential to force fiscal responsibility by reducing the ability of the government officials to authorise cost overruns and special projects. It also has the potential to reduce corruption by constraining fiscal spending. Systematic corruption is difficult to reform but dollarisation circumscribes official discretion. Assuming voters hold officials accountable, cost overruns and pet projects could become more difficult to justify and hide. The Joint Economic Committee Staff Report states that:

> A final class of benefits comes from greater economic openness and transparency, especially on the part of the government. Because there is no domestic currency that needs to be propped up, official dollarisation *eliminates balance-of-payments crises and the rationale for exchange controls* (restrictions on buying foreign currency), such as many developing countries have. By eliminating the government's power to create inflation, official dollarisation *fosters budgetary discipline*. That need not mean that the government budget must be balanced every year – Panama has run large deficits at times – but it means that deficits must be financed through the fairly transparent methods of higher taxes or more debt rather than through the murky method of printing. (Schuler, 1999, see note 16)

Dollarisation creates pressures for fiscal transparency and budgetary discipline. In fact, dollarised countries tend to have smaller fiscal deficits.[19] By forcing hard choices, dollarisation can limit some opportunities for

corruption. The inability to monetarise the deficit, in other words print more money, encourages more fiscal transparency and reduces the degree of corruption at the national level. Dollarisation, however, only works at the federal level; local corruption would remain. Dollarisation is not a silver bullet for corruption, since much corruption is at the local level because of the lower pay scales, weaker administrative systems, and higher rates of cooptation.[20]

Two measures of corruption are used in this chapter. Transparency International provides an index of corruption, created mostly from international sources. Latinobarómetro provides a measure of corruption viewed from within, by asking citizens to assess corruption in their own countries.

Most of Latin America already has demand side dollarisation; in other words, citizens already hold their domestic savings in dollars. Not surprisingly, these countries also have a high level of corruption as viewed by their own citizens. Since 1995, Latinobarómetro has been tracking perceived levels of corruption in Latin American countries (see Table 6.3). There is a correlation between countries with low rates of perceived corruption and financial liberalisation. In the case of Peru, Fujimori's clean image (until 1998) helped lower the perception of corruption. Uruguay has been pursuing a programme of liberalisation of financial markets as the 'Switzerland of South America'. Mexico's perceived corruption decreased under Zedillo, who initiated political liberalisation and continued the economic liberalisation begun under Salinas. Brazil's rate of perceived corruption had been below the mean until the currency crises, which erupted in 1997. Prior to the currency crises, Brazil had a currency board, pegging the value of the *real* to the dollar. If Brazil had officially dollarised, there would not have been a currency crises since dollarisation would have eliminated currency speculation. The Chileans have open financial and economic markets. Panama is the only country to have relatively low perceived rates of corruption in all categories for all years surveyed. El Salvador, in 1994 and 1995, announced plans to implement a currency board and in 1999 began to deliberate whether to dollarise.[21]

An examination of the European Union suggests that a single uniform currency has the potential to improve fiscal responsibility and reduce corruption. Comparing the Transparency and Corruption Index for Euro and non-Euro countries suggests a pattern of reduction in the perception of corruption in Euro countries. Countries such as Italy and Spain show improvement in post Euro years. Table 6.4 presents the corruption indices from Transparency International. Specifically, Spain joined in 1999, Italy in 1999, and Greece in 2001. Spain's score improved most dramatically, nearing the mean in the post Euro years. Greece's score remained stable and Italy experienced moderate improvement. One caveat of the Transparency

Table 6.3 Public opinion data: Latin America

	Has corruption increased or decreased in your country?				How serious a problem is corruption in your country?	
	% responding increased				% responding very serious	
	1995	1996	1997	1998	1997	1998
Bolivia	na	74	84	73	67	61
Colombia	na	76	89	83	87	82
Ecuador	na	84	93	85	74	69
Peru	21	48	73	69	60	66
Uruguay	55	73	76	72	57	60
Mexico	61	76	56	58	65	51
Argentina	70	87	92	90	88	86
Brazil	59	64	81	73	73	74
Chile	56	51	62	54	–	–
Paraguay	78	84	92	89	77	84
Venezuela	87	93	94	94	79	89
Costa Rica	na	84	92	89	82	73
Honduras	na	84	89	77	77	80
Nicaragua	na	79	84	91	80	85
Panama	na	75	66	76	68	68
Guatemala	na	–	–	–	–	–
El Salvador	na	70	61	84	55	60
Mean	*60.875*	*75.125*	*80.25*	*78.56*	*72.6*	*72.53333*
Median	*60*	*76*	*84*	*80*	*74*	*73*
Standard deviation	*19.67912*	*12.29024*	*12.943*	*11.73*	*10.32196*	*11.56884*

Source: Latinobarómetro.

International scores is that it does not differentiate among different types of corruption (i.e. local versus federal). Although many factors influence the perception of corruption, the adoption of the Euro seems to have improved scores.

ILLUSTRATIVE CASE STUDIES

Unfortunately, there are few case studies of dollarisation and conclusions are tentative. Nonetheless, early patterns suggest a potency of dollarisation

Table 6.4 Corruption indices

Year	1996	1997	1998	1999	2000	2001	2002	2003
Euro countries								
Austria	7.59	7.61	7.5	7.6	7.7	7.8	7.8	8
Belgium	6.84	5.25	5.4	5.3	6.1	6.6	7.1	7.6
Finland	9.05	9.48	9.6	9.8	10	9.9	9.7	9.7
France	6.96	6.66	6.7	6.6	6.7	6.7	6.3	6.9
Greece	5.01	5.35	4.9	4.9	4.9	4.2	4.2	4.3
Germany	8.27	8.23	7.9	8	7.6	7.4	7.3	7.7
Ireland	8.45	8.25	8.2	7.7	7.2	7.5	6.9	7.5
Italy	3.42	5.03	4.6	4.7	4.6	5.5	5.2	5.3
Luxemburg		8.61	8.7	8.8	8.6	8.7	9	8.7
Netherlands	8.71	9.03	9	9	8.9	8.8	9	8.9
Portugal	6.53	6.97	6.5	6.7	6.4	6.3	6.3	6.6
Spain	4.31	5.9	6.1	6.6	7	7	7.1	6.9
Mean	*6.83*	*7.20*	*7.09*	*7.14*	*7.14*	*7.20*	*7.16*	*7.34*
Non-Euro European countries								
Mean			*3.81*	*3.58*	*3.59*	*3.94*	*3.95*	*3.72*
OECD non-Euro countries								
Mean	*8.00*	*8.04*	*8.40*	*8.37*	*8.36*	*8.09*	*8.16*	*8.26*

Notes: 10 is most honest, 0 is most corrupt.

Source: Transparency International.

that should be researched more rigorously once more data become available. Today, however, two Latin American countries can be discussed. Additionally, the experiences of EU countries, such as Greece, Italy, and Spain are helpful to see if similar fiscal constraints can reduce corruption and waste.

Panama

Although Panama does issue local currency called the *balboa*, the US dollar is the official currency of Panama. Panama dollarised in 1904, the year of its independence. Among emerging markets, Panama is a rare example of a country with consistent low inflation, low restrictions on the purchase of foreign currency, and a stable value compared to the dollar (see Table 6.5). Panama's economy uses the US dollar as a medium of exchange, has free capital markets, hosts numerous international banks, and functions without a central bank.[22] The difference between Panamanian interest rates and US interest rates is low because Panama has a low country risk and no devaluation risk. Moreno-Villalaz illustrates that the average deposit rate in Panama is less that one per cent over LIBOR and the commercial lending rate is less than two percentages above the US prime rate. Panama is the only Latin American country that issues 30-year fixed mortgages similar to the US. The integrated banking system also reduces the corruption that results from limited capital and credit rationing, providing stability and promoting investment.[23] Panama has also had relatively low inflation. Panama's inflation only exceeded ten per cent during the oil shock times of 1974 and 1980. Panama is not plagued by episodes of hyperinflation. The stable price structure is a direct result of dollarisation. In addition to low inflation, Panama has had relatively stable growth. While Panama does not have macroeconomic disequilibria, other problems can remain. However, dollarisation and integrated financial markets create a system in which micro-distortions do not escalate into macro-distortions. Panama is an interesting case since it is an independent country that has been officially dollarised for a century. What can be extracted from the Panamanian experience is that dollarisation coupled with international financial integration may lead to lower inflation, more stable growth and sound fiscal management by the government. Although corruption has survived dollarisation, as measured by Transparency International, Panama enjoys a level of macroeconomic stability unusual in Latin America. The interest rate spread is moderate, inflation low, and Panama does not suffer from consistent deficits. Additionally, the real interest rate does not wildly fluctuate, creating a more favourable investment environment.

Table 6.5 Panamanian indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Panama									
Real interest rate	10.10	9.36	9.31	10.26	8.80	8.98	10.66	9.58	8.51
CPI % change	0.99	1.26	1.32	0.56	1.25	1.50	0.31	1.01	1.41
Deficit (−) or surplus	230.5	−60.9	17.9	−64.2	34.4	30.2	n.a.	n.a.	n.a.
GDP growth rate	1.75	7.37	6.38	7.38	3.97	2.74	0.57	2.25	4.06
TI index						3.7	3.7	3	3.4
Latin America & Caribbean									
GDP growth (annual %)	1.44	3.62	5.18	2.09	0.03	3.67	0.28	−0.79	
LA TI average*						4.02	3.88	3.44	3.70
United States									
CPI (annual %)	2.81	2.93	2.34	1.55	2.19	3.38	2.83	1.59	
Prime interest rate (%)	8.83	8.27	8.44	8.35	7.99	9.23	6.92	4.68	

Note: * denotes average of Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Mexico, Panama, and Peru. Real interest rate is the lending rate minus inflation.

Source: IMF, Transparency International (TI).

Ecuador

During 1998 to 2000 Ecuador's Central Bank maintained high interest rates to prevent the *sucre*'s devaluations. Eventual devaluation eliminated about 40 per cent of Ecuador's banks and 65 per cent of their assets. The value of the *sucre* plunged from about 7000 to 30 000 *sucres* per US dollar from January 1999 to early 2000 (see Table 6.6). The economic decline instigated severe political instability.

Faced with his country's deepening economic crises, in January 2000 President Jamil Mahuad declared the introduction of the US dollar as the official currency. This announcement initiated a period of economic reform matched by popular protest and resistance. Indigenous mass protests and a military coup forced Mahuad's resignation and subsequent exile. Gustavo Noboa replaced Mahuad as Ecuador's new president. Despite the unrest, President Noboa continued his predecessor's dollarisation policy with congressional support. In March 2000, Congress approved a series of structural reforms; the IMF, the World Bank and the Inter-American Development Bank announced a two-billion-dollar package to Ecuador for the next three years; and Ecuador began its dollarisation in earnest. On 9 September 2000 President Gustavo Noboa officially replaced the Ecuadorian *sucre* with the US dollar. Although the international financial community was pleased, popular protest against the reforms grew. In February 2001 President Noboa declared a state of emergency after nationwide mass demonstrations against austerity measures. In May 2001 the IMF approved the Ecuadorian government's economic programme and disbursed 48 of 304 million dollars in standby loans earmarked for Ecuador in April of 2000. Despite protests, Ecuador registered an estimated GDP growth of 4.3 per cent in the year 2001. The cycle of protest and reform continued with the presidency of former coup plotter and army colonel, Lucio Gutiérrez, sworn in as the new president of Ecuador in January 2003. President Gutiérrez eliminated subsidies on cooking gas, gasoline, diesel fuel and electricity, resulting in a nine day strike by oil workers, which shut down Ecuador's petroleum production.

In the face of political turmoil, high debt and inflation, dollarisation coincided with an improvement in the economy.[24] Inflation at the time of dollarisation was 107.90 per cent, but declined to 6.07 per cent by December 2003. The percentage of debt to GDP declined from 88.30 per cent in June 2000 to 42.80 per cent by December 2003. After dollarisation in 2000, inflation rapidly declined, surpluses returned and growth resumed. Prior to dollarisation, there was widespread variance in the real interest rates, making investment decisions difficult. After dollarisation, interest rates stabilised. Although the corruption scores remained stable,

Table 6.6 Ecuadorian indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Ecuador									
Real interest rate	37.05	34.90	19.56	23.03	−17.79	−32.74	−11.91	3.98	5.73
CPI % change	18.62	19.60	23.46	26.52	34.32	49.00	27.37	11.10	7.35
Deficit (−) or surplus (US millions)	−163.9	−88.7	−291.4	68.7	−99.0	90.0	98.9	135.1	108.7
GDP growth (annual %)	2.34	1.98	3.38	0.41	−7.27	2.80	5.12	3.41	3.45
TI corruption index	–	3.19	–	2.3	2.4	2.6	2.3	2.2	2.2
Latin America & Caribbean									
GDP growth (annual %)	1.44	3.62	5.18	2.09	0.03	3.67	0.28	−0.79	–
TI corruption index average*	–	3.68	–	3.49	3.60	3.80	3.83	3.27	3.66
United States									
Inflation, consumer prices (Annual %)	2.81	2.93	2.34	1.55	2.19	3.38	2.83	1.59	2.27
Prime interest rate (%)	8.83	8.27	8.44	8.35	7.99	9.23	6.92	4.68	4.12

Note: * denotes average of Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico.

Source: IMF, Transparency International.

in general, the view of Latin American nations worsened. Ecuador will be a case to watch in the future. Despite the popular protests and political instability, economic reforms were successful partially because of the inherent constraints of dollarisation.

Greece, Italy, Spain and the Euro

Greece, Italy and Spain agreed to constrain their economic policies to become members of the European Monetary Union (EMU). Specifically, member countries must correct fiscal imbalances in order to participate in the EMU. These constraints function analogously to dollarisation. Countries wishing to join the EU must privatise their economies, reduce government involvement in the economies, dismantle monopolies, remove trade barriers, and encourage flexible labour markets. Another similarity with dollarisation is that there is no lender of last resort in the EMU. No EU institution has responsibility of providing, printing or coordinating extra funds during a crisis.[25] However, there is one substantial difference between dollarisation and the EU. The EU suffers from an implementation deficit. In other words, the implementation of EU directives is dependent on the cooperation of local institutions and officials. Enforcement institutions are lacking in the EU.[26] Greece, Italy, and Spain are appropriate comparisons because of their relative lack of development and histories with clientelism and patrimonialism (see Table 6.7).[27] Greece, a member of the EC since 1981, has been a major recipient of major funding programmes to assist the country in meeting convergence goals. Nonetheless, it initially failed to meet convergence criteria. Even after joining, problems due to clientelism, a lack of transparency and a weak civil society remain.[28] After Franco's death, Spain transitioned to democracy in the late 1970s and early 1980s. Italy has struggled to balance development between the north and the south while implementing the structural reforms necessary for EU membership. EU membership affects these countries in three ways. First, domestic policy choices are constrained by the EU terms for admittance into the EMU. Second, less developed states have become somewhat dependent upon EU financial aid for development projects. Third, in accordance with EU policy, these economies are opening up through privatisation and trade liberalisation. Convergence criteria drastically reduced deficits, government debts, and inflation rates.[29]

In regard to corruption, how has the EU affected member states? As of 1998, within member states, contracting is bound by EU rules. Because of this, more infrastructure projects have come under the control of international managers. In addition, countries are threatened with the loss of EU project funds if they do not comply with deficit targets.[30] Assistance from

Table 6.7 Italian, Spanish and Greek indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Greece									
Real interest rate*	14.12	12.76	24.13	13.81	12.37	9.17	5.23	3.79	3.23
CPI % change	8.93	8.20	−5.21	4.75	2.63	3.15	3.36	3.62	3.56
Deficit (−) or surplus	−3252.20	−2904.20	−2505.40	−2125.50	−1930.00	n.a.	n.a.	n.a.	n.a.
Deficit (−) or surplus	n.a.	n.a.	n.a.	−2.40	−1.70	−0.80	0.10	n.a.	n.a.
GDP growth rate	2.10	2.36	3.64	3.36	3.60	4.13	4.17	3.86	4.28
TI corruption score		5.01	5.35	4.90	4.90	4.90	4.20	4.20	4.30
Italy									
Real interest rate	7.23	8.09	7.71	5.92	3.92	3.72	3.74	3.31	2.36
CPI % change	5.24	3.97	2.04	1.96	1.66	2.54	2.79	2.47	2.67
Deficit (−) or surplus	−122.58	−136.06	−31.03	−47.90	n.a.	n.a.	n.a.	n.a.	n.a.
Deficit (−) or surplus	n.a.	n.a.	n.a.	n.a.	0.34	−14.64	−40.76	n.a.	n.a.
GDP growth rate	2.92	1.09	2.03	1.81	1.65	3.03	1.76	0.36	0.26
TI corruption score		3.42	5.03	4.60	4.70	4.60	5.50	5.20	5.30
Spain									
Real interest rate	5.37	4.94	4.11	3.18	1.63	1.74	1.57	1.24	
CPI % change	4.67	3.56	1.97	1.83	2.31	3.43	3.59	3.07	3.03
Deficit (−) or surplus	−3606.30	−4003.50	−1909.40	−800.00	−6349.90	n.a.	n.a.	n.a.	n.a.
Deficit (−) or surplus	n.a.	n.a.	n.a.	n.a.	−6054.30	−787.10	−2261.40	−4578.90	−7198.70
GDP growth rate	2.72	2.42	3.53	3.79	4.91	4.21	2.84	2.04	2.43
TI corruption score		4.31	5.90	6.10	6.60	7.00	7.00	7.10	6.90

Table 6.7 (continued)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
EU									
GDP growth (annual %)	2.23	1.42	2.35	2.87	2.82	3.50	1.48	0.85	
Real interest rate					4.53	4.27	4.72	3.89	
Harmonised CPI % change	n.a.	n.a.	n.a.	n.a.	1.12	2.33	2.11	2.25	2.07
EU TI corruption average		6.83	7.20	7.09	7.14	7.14	7.20	7.16	7.34

Note: *Real interest rate is the lending rate minus inflation.

Source: IMF, Transparency International.

funds such as the EAGGF (European Agriculture Guidance and Guarantees Fund) or the Cohesion Fund are substantial. In Greece, Italy, and Spain prior to adopting the Euro, there was significant variance in the real interest rates. After adoption of the Euro, real interest rates not only fall, but their variance also declines. Declining growth rates are consistent with a general decline in world growth. Both Spain and Italy show improvement in the corruption scores.

CONCLUSION

How can a society with pervasive corruption change its incentive structure to discourage dishonest and corrupt behaviour? How can the case study countries of Panama, Ecuador, Greece, Spain, and Italy suggest that dollarisation reduces opportunities for corruption at the federal level and increases budget discipline? Latinobarómetro and Transparency International data suggest that countries that have dollarised, joined the EMU, or moved to liberalise their financial markets have improved perceived levels of corruption. A reduction and stabilisation of real interest rates and inflation also follows dollarisation. Early results suggest dollarisation can be a powerful tool in limiting corruption and encouraging fiscal discipline.

NOTES

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7. Western Europe: German unification, integration, globalisation – the German social market economy facing a threefold challenge

Michael Wohlgemuth

INTRODUCTION

With the breakdown of the Berlin wall, the creation and extension of a European single market and the ascent of global markets for goods, services, capital and ideas, unified Germany faces a threefold challenge. German unification, European integration and globalisation put the German model of a social market economy to the test as all three processes intensify competitive pressures on Germany's political and economic institutions.

German citizens, entrepreneurs and politicians seem quite aware of the increased opportunities and threats involved in these challenges. But the feeling that the underlying political and economic forces are beyond human control raises more uneasiness than confidence. Unification, integration and globalisation are not widely appreciated as extensions of citizens' empowerment in their capacity to pursue their private economic choices. Citizens and politicians are more concerned about a reduced empowerment to engage in effective public choices, and to rely on national policies in the face of internationalised political agendas and economic processes.

The question 'who rules?' may well be, as Karl Popper (1945 and 1950) argued, inadequate for open societies. But citizens do raise it with increasing concern. And the increasing difficulty in finding convincing answers within the realm of domestic policies illustrates changes at different levels of our social life. It becomes more and more obvious that empowerment cannot be sought in the delegated power of political representatives to determine market processes and outcomes. Rather, it means the establishment of institutions, local, national and beyond, that allow (groups of) individuals to determine their own economic and political life in decentralised

settings of social self-organisation. Economic self-organisation takes place at all levels of competitive market processes that rely on and are constrained by abstract rules of fair conduct (Hayek, 1976). Political self-organisation, if it is to empower its citizens, has to be based on systems of participation, decentralisation and subsidiarity – principles which, again, rely on collective decisions about the constitutional structure of the polity (Buchanan, 1975).

Some constitutional options for Germany and the European Union will be sketched in this chapter. The main task, however, will be to give an overview of institutional structures and developments in Germany and the EU together with assessments of their ability to cope with the challenges of an integrating world economy and to safeguard or increase citizen empowerment. Before the threefold challenge to Germany's economic order is discussed (German unification (part 3), European integration (part 4) and globalisation (part 5)) the general attributes of this order will be presented (part 2).

This is the only chapter in this volume that takes a closer look at economic and political institutions within a European country. Germany being the largest European state in terms of population and GDP, this choice may be justified. Of course, Germany is not fully representative of the various social orders one finds in Europe.[1] But core constitutional principles that characterise the German system also apply to her European neighbours: (a) an economic system that relies mainly on markets, private property and contracts, but is also exposed to state interventions and supplemented by welfare state provisions; and (b) a political system that relies mainly on representative democracy and the rule of law, but is also exposed to interest-group interventions, privileges and disturbed divisions of power. Since European integration and globalisation affect Germany in roughly the same way as other European Union members (or prospective members), my discussion of these issues is to some degree also applicable to other European countries. But first, I present two rather 'Germanic' issues: Germany's politico-economic model (part 2) and its performance during German unification (part 3).

GERMANY'S 'SOCIAL MARKET ECONOMY'[2]

Post-war Germany: Intellectual and Institutional Roots of the *Wirtschaftswunder*

Germany's social market economy celebrated its 50th anniversary in 1998 thus marking 1948 as the birthday of a political and economic style named *Soziale Marktwirtschaft* by some of its promoters and 'German Model',

capitalisme rhénan or 'third way' by others. In 1948 Ludwig Erhard, German director of the Bi-zone (British and American) economic administration, pushed through a currency reform that introduced a new and sound currency (the late *Deutschmark*) and a substantial lift of price controls. While he was largely executing plans of the military government in the case of the currency reform, he was rather exceeding his authority when administering market liberalisation. Certainly he surprised most Germans to whom the market economy was introduced as a 'big bang' and with miraculous results: consumer goods became available almost overnight and West German real GDP more than doubled during the 1950s. Labour productivity rose on average by 5.7 per cent annually and together with large amounts of domestic and foreign capital investment, unemployment was kept low despite a massive influx of refugees and prisoners of war.

What became known as the German *Wirtschaftswunder* was until the mid 1950s, a stunning event for most Germans, including all major political parties, who expected economic recovery to come more from state administration and central planning. But there was nothing miraculous about the success of the German economy (also relative to her European neighbours) for those who laid the intellectual foundations of the social market economy. The most prominent were members of the 'Freiburg School of Law and Economics' (Streit, 1994), who also called themselves 'Ordoliberals' or were known as 'Neoliberals'. This teaching and research community found itself in the early 1930s at the University of Freiburg. In its original composition it was active until the death of its prominent founder, Walter Eucken, in 1950. During the height of Nazi terror many members were forced to leave their positions and home country; others met or communicated in secret with opposition circles, planning ahead for the time after the Nazi regime's fall (Rieter and Schmolz, 1993).

The ordoliberals were looking for institutional ways of avoiding in the future two dramatic experiences of German political/economic history: (a) a highly cartellised, regulated and conflict-ridden German economy as the state was captured by vested interests during the Weimar Republic (1919–33) and (b) the destruction of civil liberties and of the rule of law during the Nazi regime (1933–45). The theoretical and political programme of the Freiburg School reflects an understanding of the mutual penetration of state and society that leads to an economic and political collectivism which has been a recurrent cause of German 'roads to serfdom' (Hayek, 1944). The common purpose is described by Franz Böhm, the Freiburg School's most influential legal scholar (1957/1960, Wohlgemuth's translation):

> the question that preoccupied us all was . . . the question of private power in a free society. This leads by necessity to the question of what constitutes an order

> of a free economy. From there one arrives at the question: which kinds of economic orders are feasible, which role does power have in each of them – the power of government as well as the power of private persons and groups – and what obstructions of order arise if a distribution of power emerges within state and society that differs from the one that conforms to the respective economic system?

These questions referring to 'power' and 'order', the key notions of ordoliberalism, differ from concepts commonly used in economic or legal science. For the Freiburg School, they define a field of common theoretical interest and political concern that focuses on the basic concept of a competitive order (*Wettbewerbsordnung*). It aims to establish 'order' as a set of legal rules for a society of free citizens whose actions are co-ordinated and controlled by market competition. It is a key message of the Freiburg tradition that private (market) power not only reduces the freedom of the many in favour of domination by the few within the economic system; it also penetrates and impairs the political system.

Ideal Type Economic Institutions: *Wettbewerbsordnung*

The question 'what constitutes an order of a free economy' was understood as a problem of an adequate legal order. Free market exchange requires a system of rules that define a protected domain of private action (property rights) and allow cooperation of equals (private contracts) where they seek it and settlement of conflicts (arbitration) where they need it. A society that builds on these principles is primarily a private law society (Böhm, 1966/1989). But private law does not provide a sufficient answer to the question of private power. This was a lesson drawn from German history: during the years of the German empire and of the Weimar Republic, private attempts to close markets (for example through the formation of cartels) were considered legitimate uses of the freedom of contract, and boycotts or collective discrimination applied against outsiders received support from the courts. As a consequence the freedom to compete was curtailed and economic power emerged within the body of private law. Ordoliberals insisted on supplementing the private law society with an institutional guarantee of open markets in order to ensure that market competition could display its central function as 'the most ingenious instrument to emasculate power' (Böhm, 1961).

Hence competition is not only (and not even primarily) regarded as a means to achieve 'economic' goals such as growth and efficiency. It must be made to serve as a procedure that curbs economic power and prevents privileges. And economic power is regarded as evil not only because it impairs the price mechanism's allocation function but also (and primarily) because

it infringes others' freedom to act. The institutional framework of the competitive order is most prominently described by the principles laid down by Eucken (1952/1990). As a 'fundamental principle' the creation of workable competition is postulated. As 'constituent principles' conducive to the competitive formation of prices and the control of power, he defines the stability of the monetary system, open markets, private property, freedom of contract, strict liability and the steadiness of economic policy. Necessities for political intervention that might still arise should adhere to 'regulating principles' such as monopoly control, subsidiary income transfers and wealth taxation and the correction of externalities. In contrast to what they regarded as 'laissez-faire' liberalism, ordoliberals stressed that 'a private law society cannot function without authority . . . it requires a support, which it cannot produce from within its own resources, in order to function at all' (Böhm, 1966/1989). By conferring such an authority to government, a second problem of power emerges: political power.

Ideal Type Political Institutions: *Rechtsstaat*

Ordoliberals sought to protect competitive market processes mainly in their capacity to curb lasting power relations. Their aim was to empower consumers and entrepreneurial entry. This affords a strong but limited government. Politicians must be strong to be able to disempower monopolies and pressure groups, thus defending the competitive order. At the same time, they must be limited to the pursuit of this genuine task and confined to the use of liberty- and market-compatible means of political authority. The belief that a strong and limited state is no contradiction in terms and that political authority and constitutional limitations are complementary, became a central tenet of ordoliberalism.[3]

This conception of a *Rechtsstaat* or rule of law is far from implying 'benevolent dictators' who still loom in welfare economics. Eucken (1952/1990, Wohlgemuth's translation) made this very clear: 'It is wrong to see the existing state as an all-knowing, all-powerful guardian of all economic activity. But it is also incorrect to accept the existing state which is corrupted by interest groups as irreversibly given and consequently to despair of mastering the problem of building a proper political-economic order.' Eucken and Böhm exposed the institutional conditions of what later became known as the 'rent-seeking society' (for example Tollison, 1982); they proposed institutional precautions to prevent a refeudalisation of society they witnessed in German history. A constitution based on fundamental individual rights that cannot be infringed by the state; a genuine division of political powers with independent courts; a representative democracy; a decentralised federal composition of the state; and

independent authorities with limited specified tasks (such as monetary and anti-trust policies) were demanded as safeguards of a free and stable economic and political order.

The Politico-economic Concept: *Soziale Marktwirtschaft*

Besides members of the Freiburg School, other economists prepared the advent of the Social Market Economy and politically managed its seemingly 'miraculous' success. Alfred Müller-Armack, a social scientist and later a high official in the ministry of economic affairs, coined the politically effective term *Soziale Marktwirtschaft* which was meant to dispel Germans' fears of uncontrolled *laissez-faire* market processes. He also put the basic idea in one single phrase, namely 'to combine the principle of freedom on the market with that of social equilibration' (Müller-Armack, 1956, Wohlgemuth's translation). To make sure that 'social equilibration' is not pursued in a way that would violate the 'principle of the market', economists, lawyers and politicians worked hard on various 'conformity' principles which were to work as guidelines for selecting appropriate instruments from the politicians' tool-kit and for framing the judgments of German courts. To be sure, none of these strictly adhered to such conformity rules and none made its way into German public law.

The idea of harmonising freedom of the market with social equilibration could not successfully frame German politics. Rather, some of Müller-Armack's ideas on social policies (such as co-determination of workers, progressive taxation, social transfers, minimum wages, subsidies for small and medium sized firms, subsidies for housing, or business-cycle stabilisation) were taken up by rent-seeking interest groups and vote-seeking politicians without much regard for the abstract principle of 'free markets'. The ensuing policies revealed tensions between the self generating character of markets within the 'private-law-society' and attempts to (re-)direct this spontaneous order with the use of politically centralisable knowledge and politically controllable means of public law.[4]

In remarkable contrast to ordoliberal warnings, the German welfare system developed through corporatist structures. These were already created under Bismarck on the basis of existing mutual aid associations and remained the basis for social protection subsequently. Social insurance, which covers the costs of health, social care and much of the income maintenance system, are managed by a system of independent funds. This arrangement also reflects a biased understanding of the principle of subsidiarity. This principle is taken to mean that services should be managed independently from direct state influence and that the level of state intervention should be residual – that is, limited to circumstances which are not

adequately covered by private provision and charity. However, corporatism and etatism soon became close allies, again fostering a collectivist blend of centralisation, rent-seeking and welfare paternalism, thus obscuring a clear division of individual and governmental responsibilities.

More than any previous event, German unification revealed the innate tension between a collectivist understanding of the 'social' element and the individualistic mode of the 'market' element within the German model of a social market economy.

GERMAN UNIFICATION: TRIUMPH OR DEFEAT OF THE SOCIAL MARKET ECONOMY?[5]

The preamble to the treaty establishing the terms of German unification (the *Einigungsvertrag* of 1990) for the first time gives the social market economy legal status as Germany's economic system. But at the time of its seeming consummation as a constitutional principle, many observers claim that the social market economy in its original meaning has lost its grip on German politics (Cassel, 1998). True, the West German market economy has triumphed over East German central planning; but the economic system that was introduced in the former GDR turned out to deceive many hopes of the new *Länder*'s citizens.

West Germany's market economy and welfare state were introduced at the same time and almost without amendments that would reflect the conditions of a land devastated by political oppression and economic bankruptcy. It turned out to be the market's task to reveal the economic disaster of 40 years of socialist planning: a complete lack of marketable goods and a dismal state of capital structure. At the same time the 'social' element of the social market economy was introduced which already in the old Western Germany took on institutionalised proportions of an overburdened welfare state.

One of the few 'market conform' political acts that would have dampened or at least delayed the 'creative' destruction of the GDR's economy would have been to set a (shadow) market price for the conversion of GDR currency into *Deutschmark* (estimated at around 5:1). Instead, the government found it politically expedient to transfer East German monetary wages 1:1; debts and liabilities 2:1. With labour productivity at around 20 per cent of West German standards and labour costs pushed towards parity, East German businesses (even if they hoped to produce marketable goods) could only be privatised with the help of enormous state subsidies and guarantees.[6] At the same time, German unions and firm representatives[7] determined wages and labour protection under the conditions of

Germany's sector-wide collective wage bargaining system and under high political pressure to approach wage parity with the West. An even more substantial drop in employment was cushioned by state-financed work provision and training schemes creating artificial labour demand, while early retirement schemes aimed to reduce labour supply. Many unemployed were thus either pushed out of the statistics or made de facto trainees and state employees (Heckman, 2001).

The combined effect of fully integrating East Germany into highly competitive product markets while at the same time introducing a highly inflexible labour market organisation, mandated social security and generous transfer systems has been that the 'blooming landscapes' (promised by Chancellor Kohl during the first all-German free general elections) turned out to be 'blooming illusions'. The German welfare state was not prepared to deal with such formidable needs for economic adjustment. West Germany, if left alone, might have been able for a few more years to endure the rigidities of her labour markets and to delay the collapse of a social security system strained by an inflation of claims on social transfers despite dramatic demographic decline. But with the sudden integration of East Germany these West German 'achievements' ran into mischief.

Whilst no other former socialist country in transformation was as 'lucky' as the former GDR to have a complete system of institutions ready for use and a rich brother ready to pay the bill, none of these countries was forced to cope with a comparable amount of sclerotic conditions apt to suffocate the emergence of competitive market structures right from the beginning. The combined effect was that the new *Länder* were falling behind other transforming East European societies in terms of unemployment and growth rates. This, one can argue, would not have happened had West Germany not in the last decades added more and more interventionist policies to its initially more market-oriented economic constitution.

Understandably, East Germany did not want to become the playing-field of any more political experiments; its citizens were looking forward to their share in the 'social' component of what they expected the social market economy to be. In addition, considering Gorbatchev's precarious political power base, the geo-strategic window of opportunity was most likely reduced to a very short space of time. This was no time to start rethinking the West German social order before offering it to East Germans. But for the sake of the flexibility badly needed to account for the massive needs of structural change, one would have welcomed the use of more opening clauses allowing (temporary) deregulation and decentralisation not only in areas of collective wage bargaining but also with regard to administrative laws and regulations.

The German economic system's popularity in the East has meanwhile deteriorated dramatically, almost to the point of threatening German unity in terms of shared mental models and political beliefs. Recent polls show that in 2005, only 10 per cent of East Germans think well of the German economic system; in the year of German unification (1990) the number was 77 per cent; West German contentment has meanwhile declined to 29 per cent in a survey quoted in *Frankfurter Allgemeine Sonntagzeitung* (27 March 2005).

Today many economists and a few politicians regard East German experiences as potentially instructive for Germany as a whole. The West might have to learn from the East such different qualities as the ability to suffer and the willingness to adapt to new circumstances. Unemployment in February 2004 was 8.5 per cent in West Germany and 18.4 per cent in East Germany.[8] In both regions, it is predominantly structural, not cyclical. Hence German labour markets are not amenable to Keynesian demand management; nor does German unemployment simply reflect world market activity – as government officials like to see it. Economists blame above all the sector-wide determination of wages involving centralised unions and the economy-wide political creation of non-wage labour costs, both failing to reflect regional and firm-specific conditions of economic activity; strict employment protection laws creating a high reluctance to hire labour; and a dense net of business regulations inhibiting market entry and retarding structural change even further (e.g. Heckman, 2001; Siebert, 1997). German unification is only one challenge to this regulatory environment. German integration into a European and global environment of increased turbulence and competition further increases the challenge.

EUROPEAN INTEGRATION: EMPOWERING SUPRA-NATIONAL AGENCIES OR CITIZENS?[9]

In the fields of competition policy and monetary policy, Germany remained comparatively loyal to ordoliberal principles. Specifically in these fields, politically independent agencies were empowered with taking care of public interests: an anti-trust office (*Bundeskartellamt*) and the famous *Bundesbank*. Both acquired a reputation for withstanding the assaults of rent-seekers and the lure of short-time political gains. Both became institutional settings admired in many parts of the world. And both have now been totally or partly replaced by European agencies. Until now the European Central Bank and European anti-trust regulations have been fairly successful in fighting inflation and monopolisation. At the same time the European authorities had much less success in their attempts to enforce

budgetary discipline within member states (the stability and growth pact has failed dismally) or to promote open market access when it comes to state-owned enterprises or foreign trade.

Constitutional Choices

A full description and discussion of the manifold aspects of European Union institutions and policies is beyond the scope of this chapter. I can only sketch a few basic constitutional choices that European organisations and EU member states are facing at the moment. It is only with the introduction of the euro as the common currency of 12 EU member states that European institutions have started to dominate most vital aspects of Europe's economy. National governments have long lost control of trade policy and agricultural policy; and recently most EU member states gave up control of monetary policy. In addition, important regulations concerning anti-trust, consumer protection, public health, product norms, environment, industrial structures, subsidies, research and development, energy, banking, education, economic and social cohesion, immigration, regional development, together with aspects of foreign and security policy and some taxes are today either directly allocated to Brussels or have to comply with European standards. The accelerated centralisation and harmonisation of policies, however, has not been accompanied by an intensified direct democratic control of European legislation. In addition, the *aquis communitaire*, i.e. the established laws and regulations each member state has to comply with, have erected substantial barriers to entry into the Union. With EU enlargement as a desideratum and the overhauling of the European constitutional texts and decision procedures on the present agenda, the discussion is alive as to what we want the future Europe to be.

Roughly speaking, there are two camps preferring two different constitutional options. Some opt for an ever closer union and follow a vision of a European State with all major attributes of sovereignty (such as a central government and a single parliament with direct legislative competence to make laws for all EU members). Others aim at an even larger single market based on the necessary legal requirements (such as the free movement of labour, capital, goods and services), but with most of the remaining sovereignty staying with the national governments. European reality and the preferences of most European governments stand somewhere between those radical options (with, for example, German officials traditionally within the first camp and British officials more firmly in the second). Thus, neither a European super-state nor a return to a European club of free-traders find winning coalitions. But there is a substantial struggle between

the camps that shapes European discourse about many practical matters on the present agenda:

- Should different product norms, labour market regimes, or consumer protection regulations be allowed to compete among nation states (following a principle of origin rule); should they be harmonised (through agreements among member states); or should they be centralised (directly allocated to European agencies)?
- Should national tax systems and social security systems be harmonised or centralised; should they remain decentralised?
- Does monetary union afford a European co-ordination or centralisation of fiscal policies?
- Should the Union's responsibilities remain (more or less) confined to explicitly stated and limited tasks or should the Commission, the Parliament, or the Council be given more leeway to take over tasks where they see fit?
- Should member states who favour closer integration be allowed to co-ordinate their policies while leaving it to the others to stay out (or opt out) if they so wish ('two-speed Europe'; 'Europe of concentric circles')?
- Should the unanimity principle within the Council of Ministers (the most important decisionmaking body of the present EU) be abandoned in order to strengthen European agencies' capability to act also with regard to decisions that seriously affect member states' sovereignty and constitution?
- Should the European Parliament be given more rights to decide by majority voting on legal and constitutional matters? Should it be given priority rights of legislative initiative? Should it elect a European government?
- Should the national sovereign, i.e. the people in the member states be asked via referenda if they consent to their governments' European policies and treaties (which can involve giving up great amounts of national sovereignty)?

European governments and citizens are far from reaching consensus on these elementary questions concerning a future Europe. Despite common quarrels about European bureaucracy, the odd case of corruption, political barter producing opaque package deals and an economically absurd agricultural policy, European integration with its single market as the institutional core can be regarded a success. Falling boundaries for citizens and goods have not only led to a more efficient allocation of European resources, but also to a much more natural and peaceful interaction of

European citizens. Conflicts between European nations (at least within the EU) have become a matter of normal politics, of the very common bargaining over posts, transfers, costs and benefits. Considering Europe's belligerent past, this is no minor achievement.

But the question remains: how much Europe do Europeans want? Many economists argue that, although further Europeanisation of, say, defence policies or the prosecution of crime is certainly desirable, the marginal returns of centralisation and harmonisation in most areas of economic policy have already become negative or will do so soon (Robinson, 1999). The trade-off between an enlargement of the Union's common market and an intensification of European institutional coherence has already been mentioned. The more general trade-off is that between 'integration from above' and 'integration from below'.

Integration from Above or from Below?[10]

Integration from above is characterised by common policies that empower supra-national agencies to pursue specific targets. Integration from below relies on a set of common rules that empower European citizens to pursue their individual targets in an institutionalised order of competing jurisdictions. Citizens in the first setting are able to enjoy (or forced to endure) the same rules and regulations across Europe. Citizens in the second setting are free to choose among institutional arrangements. And their governments are forced to choose among policies that not only have to please domestic voters but also attract foreign mobile resources. Citizens in the possession of mobile resources (capital and labour) would be able to engage in 'institutional arbitrage'; their 'exit' to other jurisdictions exploiting politically (co-)determined differences of expected yields (public good services) and costs (fees and taxes). This would involve an individual choice of collective rules (see Wohlgemuth, 1995).

Integration from below is not aimed at 'integration' in the sense of uniformity; it is not simply a spontaneous road to harmonisation. It is a way to match different and changing needs and circumstances with a changing variety of political and institutional problem solutions. 'Ex post harmonisation' via competitive selection is only one possible outcome. And it need not be the final outcome since, as with competition in general, inter-jurisdictional competition is open to the introduction of novelty. Developing institutional innovations may turn out to be just the right strategy for political entrepreneurs to attract resources and convince voters.

Both integration from above and from below involve potential risks and benefits. Integration by centralisation or harmonisation can help exploit

economies of scale, reduce transaction costs and by standardising the rules of the game it may intensify competition on markets for capital, labour, goods and services. On the other side, it would only be natural if demands for a 'level playing field' are motivated by politicians' and interest groups' interests to cartellise in an effort to evade competitive pressures on their sclerotic domestic institutions and practices.

Harmonising or centralising exactly those policy areas that might otherwise trigger their constituents' willingness to exit not only reduces pressures to engage in political reforms that might hurt vested interests; it also raises rivals' costs (for example, of member states that cannot afford comparatively expensive social standards). In terms of empowerment, integration from above reduces the citizens' ways of expressing their discontent while obstructing their 'exit' (see Hirschman, 1970). And the citizens' voice would be further weakened by allocating political responsibility to supranational authorities, thus diluting the value of a single vote – even if there were a fully empowered European parliament representing some 455 million Europeans (today's EU of 25 member states).

Integration from below means for national politicians that their monopoly of coercion is partly prised open. Citizens as owners of mobile resources can now escape the 'forced consumption' of domestic policies if they find other jurisdictions that provide more attractive combinations of costs (taxes) and benefits (public goods). Such competition among jurisdictions could be expected to create incentives of domestic governments to improve the efficiency of their services (Dye, 1990).

Perhaps even more important, integration from below could serve as a 'discovery procedure' in exactly the sense described by Hayek (1968 and 1978). Citizens' individual choice of rules (instead of their collective choice of rulers) could reveal their political preferences and trigger a process of parallel (instead of consecutive) experimentation with different solutions to political problems (Wohlgemuth, 2002; Vanberg, 1993). Both processes combined would serve as a procedure for the discovery of such preferences and solutions as, 'without resort to it, it would not be known to anyone, or at least would not be utilised' (Hayek, 1968 and 1978).[11] Consecutive learning from the successes or failures of centralised policies conveys far less information than parallel learning from experiences with alternative institutional arrangements tested in similar circumstances by similar citizens at the same time.

Moreover, integration from below is a less risky strategy. Failures are more easily discovered and corrected at competing lower levels than in systems that rely on one universal political hypothesis underlying one set of uniform institutions. If all member states are made to serve the same political ideas and to follow the same rules, solutions to political problems can

be proved inexpedient only by the decline of the whole conglomerate of nations guided by them (see also Hayek, 1960).

Integration from below thus presents the more adequate procedure if we have to deal with laws and regulations that concern citizens in different jurisdictions whose preferences differ and can be expected to change, or whose interests are not well known or not well taken care of by their domestic governments. In these cases, variety, decentralisation and openness are preferable to uniformity, centralisation or protectionism. Integration from above, in turn, is all the more recommendable the more one can rightly assume stable and uniform preferences together with omniscient and benevolent politicians.[12] Surely, if the best fiscal policy or the best institutional setting is known in advance and if this one solution fits all, why let there be competing policies, some of which would necessarily be non-optimal?

Legitimising Europe[13]

Legal institutions and policies are no 'consumption goods', the value of which is independent of their origin and mode of production. Political 'production processes' derive their importance not least from how they utilise the scarce resource 'legitimacy'. Both integration from above and from below are problematic in this crucial respect.

Integration from below based on citizens' exit and competing jurisdictions causes legitimacy concerns if disproportional opportunities to make effective use of 'exit' exist (as surely is the case for capital ownership) and if disproportional political influence can be achieved through (threatening with) 'exit'. In fact, as can be observed with tax policies around Europe, fiscal burdens are increasingly put on immobile resources, whereas owners of mobile resources (above all international firms) are increasingly exempt from effective taxation either through general legislation, strategic bargaining or investment in 'tax havens' (Scharpf, 2000).

Alternatives to 'institutional arbitrage' in the European single market or the globalised world economy also involve severe legitimacy problems. Realistic alternatives are harmonisation or centralisation on supra-national levels or a return to domestic 'sovereignty' by means of erecting national barriers to exit (and entry). The first alternative not only means that citizens are deprived of their ability to choose among institutional alternatives. It also means that they become subjects to laws and regulations of which the democratic legitimisation is highly dubious. European laws and policies are adopted in the Council of Ministers and become effective as national law – trumping even national constitutional law, without the direct participation of national parliaments. The stream of legitimisation envisaged by

classical liberal principles of the division of powers is almost reversed. As Vaubel (1995) put it:

> Whoever thought that, in a parliamentary democracy, governments are controlled by their parliaments should note that, in the European Community, the national ministers assembled in Brussels jointly control their parliaments.

In fact, EU decisions at the moment lack direct democratic legitimisation through parliamentary participation. The indirect legitimacy that members of the national executive derive from their being elected at home may suffice as long as single governments have veto power. It becomes the more problematic the more unanimity requirements are replaced by majority decisions in the EU. The jointly ruling representatives of national governments cannot assume a mandate from citizens of the overruled member state. And the fact that votes in the Council are by no means proportional to the populations in the respective countries further increases legitimacy concerns, especially if unanimity is no longer required.

The seemingly obvious response to these problems, to vest the European Parliament with prerogative to initiate and make European laws and regulations, creates its own legitimacy problems. The empowerment of European citizens to control their domestic (political and private) life would not necessarily be enhanced. Distances between the political *Lebenswelt* (the social environment that is experienced and can be evaluated by individuals and groups) and political decisions would become even longer. And relations between the citizens' preferences, opinions and votes and their 'consumption' of public goods (or bads) would become even more strained.

European politics lacks a crucial condition for the workability and legitimising effects of representative democracy: a European public sphere, that is, European arenas for political discourse and the creation of a European public opinion (Schlesinger, 1999; Grimm, 1997). Public policies should preferably be made where they encounter a public opinion that can at least be mobilised in cases of strong discontent. Except in a few élite circles a trans-national (and trans-lingual) political discourse does not take place; moreover there are no major pan-European political parties or mass media.[14] Extending the production and provision of political goods and services (and their funding) beyond the realm of a public that can articulate its needs and opinions diminishes the prospective quality of the political good. The European bourgeois, empowered with economic resources, has traditionally been a 'man of the world', as Adam Smith (1776/1974) observed. The European 'citoyen', empowered with political rights to control her life and that of others, however, is by no means Europeanised yet. The world she can subject to reasoned judgements is more confined.

The second alternative to 'integration from below' based on competing jurisdictions within a framework of common rules of the game is even more dubious. A nation's retreat from the European Common Market, limiting the freedom of its citizens to relocate their assets (and themselves) would not be an act of sovereign self determination but a blatant breach of international law. Barriers that national governments erect to prevent their citizens from trading and bartering with foreigners also curtail the rights of those foreigners to engage in mutually advantageous exchange. This would deprive Europeans of their right to self-determination in open markets, leaving only the collectively diluted right to co-determination via voting on electoral promises.

GLOBALISATION: OPPORTUNITY OR THREAT?

Much of the discussion of European politics can also be applied to the issue of 'globalisation'. In both cases, the increasing transnational mobility of factors of production empowers those who own them, enriches those who successfully combine them to produce marketable goods and reduces the ability of national governments to tax and regulate them. The political alternatives to this process are, as extreme types, also the same: (a) 'integration from above' through centralisation and harmonisation of economic policies, (b) 'integration from below' through competition among jurisdictions under conditions of free trade or (c) 'disintegration' through national retreats from the international division of labour.

The first option is naturally more demanding in the case of globalisation than with European integration. Even those who call for a European 'super-state' usually refrain from demanding something like a 'world government' – although it is hard to see why the logic of their argument should stop short at the shores of Gibraltar or the Atlantic. But certainly, the above-mentioned legitimacy problems would abound, not to mention political feasibility. The third option, by contrast, is largely ruled out for members of the European Union as far as it concerns barriers to trade among themselves. On a global scale, a new era of protectionism (involving trading blocks such EU or NAFTA *vis-à-vis* the rest of the world) may be more likely in terms of political temptations in a field where legal self-binding constraints are weaker – although it is highly questionable if radical retreats from international trade, including the treaties and institutions that protect it, would be reasonable (Henderson, 2000).

With both extreme cases of a world government and a re-nationalisation of national economies being rather unlikely, globalisation involving the mobile bourgeois and the immobile citoyen remains the only viable

alternative in the near future. And the only practically relevant question is whether globalisation can and should be governed by different rules of the game, especially such rules as would define legal limits that international businesses and national governments should respect. I cannot here deal with these big issues in any detail.[15] Rather, I want to come back to my narrower subject and briefly sketch the challenge that globalisation presents to Germany (and most Western European welfare states in similar ways).

The German Market Economy in Global Competition

Germany is one of the world's most open economies. In 2004, imports amounted to 720 billion euros (33.2 per cent of GDP) and exports were at 835 billion euros (38.5 per cent of GDP). But Germany's position on the global markets suffered during the last decade. In particular, Germany's market share in the 'new economy', the global trade in services, information technology and biotechnology, is rather low. Moreover, direct investment in Germany remains largely behind the share of real capital investment that comparative locations can acquire from abroad. Germany no longer seems a very attractive location for businesses. And German enterprises increasingly invest outside Germany.[16]

In terms of income per capita Germany is still among the world's richer countries ($25 250 in 2003), ranking however a rather modest twenty-second (World Bank). And in terms of growth dynamics and employment, Germany has fallen behind most of its European and global competitors. Observers such as the *Economist* (1999) or Paul Krugman (1999) identify Germany as 'the sick man of Europe'. For many years, Germany rivals with countries such as Portugal and Greece for being the EU's worst performing economy in terms of growth and public debt.

Labour costs have traditionally been high in Germany. But a modern capital structure and high productivity have for many years held unemployment comparatively low. This situation has changed.[17] With currently (February 2005) 5.2 million unemployed (14 per cent of the labour force) it will take real growth rates in Germany of well above 2 per cent to have any positive effects on employment and offset the adverse effect of German unit labour costs that are among the highest in the world. In 1999, labour costs in manufacturing were 39 per cent above the average of industrialised countries. The biggest portion of the gap is due to non-wage labour costs which exceed the OECD average by 67 per cent (OECD, 2001). In some areas, employers have to pay almost as much in additional costs for funding their workers' social benefits and social security as in direct wages.

Labour costs are also rigid. Direct pay rises are negotiated by unions and employer organisations industry by industry. Thus wages are very much the

same throughout Germany no matter if the region or firm is prospering or declining. Adding to the mix of exuberant non-wage costs and rigid wage structures, comparatively high tax burdens, high regulatory and administrative barriers to business entry, high levels of employment protection and labour co-determination within firms, Germany's competitive disadvantage on dynamic global markets is no miracle to economists.[18]

Differences in economic results also reflect differences in political and institutional settings. In the following section I will briefly discuss some aspects of German politics that created a welfare state which gradually replaced the traditional concept of a social market economy and which is about to be displaced by the dynamics of global market processes.

The German Welfare State in Global Competition

The German constitution does not prescribe a particular economic system. It does, however, stress that Germany adheres to the principle of a 'social state' (*Sozialstaatsprinzip*). In contrast to the liberal provisions of the constitution that act as a protection of individual rights against state interference, this principle assigns to politicians an 'unqualified authorisation' (Ernst Benda, former judge of German supreme court: Benda, 1984) to interfere with private property rights – not only (but mainly) by ways of correcting market results via redistribution. As can be observed in many other welfare states, such policies were not particularly effective in helping the poorest (for example, Lindbeck, 1985; Acemoglu and Robinson, 1999). Rather, they empowered the loudest – those who command the most powerful 'voice' due to their organisational power – to obstruct government policies and influence voters. The political logic of an almost irreversible growth of government expenditure and state intervention, the ineffectiveness of even well-meaning social policies to help the poor and unemployed and the damaging effects of state interference with competitive processes on the economy's potential for growth and structural change have been exhaustively analysed by economists.[19]

Perhaps some more data may illustrate this point: the share of government expenditure in GDP has risen from 33 per cent in 1960 to almost 50 per cent in the 1990s. The fiscal expansion in the 1960s and 1970s was followed by a modest consolidation process in the 1980s which came to an end with German unification. Massive transfers to Eastern Germany increased the share of government expenditure to more than 50 per cent in 1995. For 2000 it is estimated at 47.2 per cent (OECD, 2001). Most of the total and of the increase in government spending is related to social transfers and state contributions to social security. The general impression of the public, however, is curiously at odds with this reality. When asked if the

'market' or the 'social' element dominates in Germany's social market economy, 54 per cent of the respondents found the market dominating and only 10 per cent observed that the 'market' element has in fact declined dramatically. With the German state now spending almost half of national income, Germany has become a welfare state the size of which none of the founders of the social market economy could have imagined or would have approved.

As indicated in the introduction to this chapter, there is a general feeling that Germany must change some of its cherished welfare state traditions in order to stabilise the social security systems facing dramatic demographic change, to regain competitiveness on global markets and to play a more prominent role in the 'new economy'. When it comes to particulars, however, the resistance of vested interests, the reluctance of incumbent politicians and the repercussions of German modes of policymaking are almost insurmountable.

These three elements are mutually reinforcing. The first two obstacles are rather common to welfare states (e.g. Streit, 1987; Williamson and Haggard, 1994; Lindbeck, 1995; Wohlgemuth, 1999). To take away group-specific privileges such as exemptions from competition (or compensations for its effects) and to lower accustomed claims on social insurance and transfer systems involves a political ratchet effect: such favours are easy to distribute but hard to dismantle. The following aspects make it risky for politicians to engage in welfare state reforms that should ultimately benefit the large majority, but that in the short run – like all investments – will involve sacrifices: (a) the benefits may be substantial, but they are not as visible as the sacrifices; (b) the benefits appear only in the longer term, the costs are felt much earlier; (c) the benefits may accrue to a large majority, but they are widely dispersed and difficult to relate to particular policy changes while the costs are evident and concentrated on special groups; and (d) the beneficiaries mostly belong to unorganised and uninformed latent groups (tax payers, consumers, later generations), while (short term) losers mostly belong to powerful pressure groups and organisations who dominate public opinion and have direct access to political decisionmaking. Hence, politicians and interest group representatives interested in power, posts and income, discount the future benefits of welfare state reform and focus on visible short-term losses to specific constituencies.

Specific German formal and informal procedures of policymaking further support this behaviour. I have already mentioned the corporatist structure of German labour markets and welfare systems. Introducing reform into these areas would affect established governance structures that grant vested interests a dominant influence on the German welfare state. German governments thus have to resort to moral persuasion and 'round

tables' to talk the semi-public, semi-private 'social partners' to accept reform proposals. Short-term regards to the respective constituencies lead to symbolic policies, a temporary camouflage of symptoms, or logrolling at the expense of misrepresented third parties (see Streit, 1988).

Any federal government open to reform would be impeded by a further 'joint decision trap' (Scharpf, 1988) created by the German system of a two-chamber legislative. German laws have to pass the *Bundestag* (the federal legislative assembly electing the German government) and the *Bundesrat* (the assembly representing the *Länder* governments). This multi-layered governance structure creates additional occasions to form veto-coalitions and obscure political responsibilities. Especially if (as has often been the case) both chambers are dominated by opposing party coalitions,[20] obstructive voting along party lines has often occurred with the effect of further blocking or delaying reforms.

The German economic and political system has been in place for many decades. Viewed in isolation, it cannot explain Germany's growth in unemployment and decline in competitiveness. The German welfare state has grown during the last 30 years and recently some of its incentive problems have been reduced through tax reforms and first attempts to limit the impact of ageing on the pension system (OECD, 2001). German unification, as argued, has also contributed to the consolidated low performance of the German economy since the 1990s. But the major cause and the lasting challenge remains the unfolding of globalisation.

The world economy is changing at a faster pace than the German economy and politics are currently able to keep up with. As James Heckman (2001) observes:

> We live in an era of creative destruction . . . This is an era of greater risk and greater return. The modern welfare state even at its newly reformed level is maladapted to this new world economy because it discourages risk taking and efficient adaptation by providing 'social insurance' to preserve the status quo at precisely the time when many old economic practices are no longer productive.

The German economic and political institutions and habits have not so far proven an ability to respond to change rapidly and radically. Hence, German citizens' uneasiness with globalisation is not unwarranted.[21] The major challenge still lies ahead.

SUMMARY AND OUTLOOK

The ordoliberal thinkers, in their most principled beliefs, were ahead of their time. Stressing the need for a competitive order based on rules of just

conduct and a liberal order of government under the rule of law, they envisaged a society that empowers citizens and reduces arbitrary power within state and economy. These principles are still up to date and accepted in more parts of the world today than they were then. The German social market economy, built on these principles, had its big time during the 1950s and 1960s. But by slowly and almost imperceptibly degenerating to a corporatist welfare state, the German model became rather outdated, unable to keep pace with the changes domestically (such as ageing populations and an overburdened social security) and internationally (e.g. new technologies and new markets). The economic and political order that was rather well adapted to the more stable and predictable economic environment of the 1950s and 1960s becomes dysfunctional as the world becomes more turbulent and uncertain (Heckman, 2001).

The first major challenge to what became of the social market economy was German unification. It not only revealed the bankruptcy of East German socialism. It also pointed at limitations of the (West) German welfare state's ability to cope with massive needs for structural change. It may even have fuelled an apprehension of what lies ahead if German political and economic institutions remain as static as they were and mostly still are.

The second major challenge to Germany and her neighbours is to institutionalise future integration and enlargement of the European Union. Attempts to create a European welfare state may for a while mitigate pressure on Germany (and other EU member states) to undertake painful reforms at home. But they will not buy much time in a world economy that remunerates flexibility, mobility and decentralisation. Especially under conditions of turbulent change and uncertainty, integration 'from below' through inter-jurisdictional competition, decentralised experimentation and flexible co-operation seems a more promising approach to discovering and using local knowledge, skills and solutions.

The third challenge, globalisation, sets the present and future agenda for national and European policies – like it or not. Germany as one of the world's most open economies is particularly exposed to the threats and opportunities of intensified global competition. The costs of protecting insiders and preserving the welfare state's status quo have increased in the new world economy. Corporatist structures delay responses to a need for more flexibility and decentralisation. Under these circumstances it would take a true economic 'miracle' to offset institutional sclerosis. But the opportunities are still out there. And there is no lack of scientific advice based on a comparative institutional analysis. But there is no Ludwig Erhard Jr who could once more break political deadlock – thus empowering and encouraging German citizens to meet the challenges ahead.

NOTES

1. Historically, variety among institutional arrangements and rivalry among small states for business relocations may have been crucial factors for Europe's success in creating wealth and defending individual liberties (see Jones 1987).
2. The most comprehensive English source of original key writings and interpretations concerning the social market economy's history of events and of ideas is Peacock/Willgerodt (1989a; 1989b). Other interpretative essays are Willgerodt (1976); Hutchison (1981); Giersch/Paqué/Schmieding (1992); Kasper/Streit (1993); Sally (1998, part III) and Wohlgemuth (2001).
3. Eucken (1932: 307) learned from German history that the 'expansion of government activities . . . not at all meant a strengthening, but to the contrary, a weakening of the state'. The corruption of the political order, the unreliability of economic institutions combined with politicians' dependence on economic power groups, is a prominent example of the general idea of an 'interdependence' of the legal, political, and economic order (e.g. Eucken 1952/90: 332ff). The analysis of a 'capturing' of the state by vested interests still describes today a central reason for modern welfare states' political and economic weakness (e.g. Stigler 1971; Olson 1982).
4. There are differences in emphasis between Müller-Armack's and Ordoliberals' accounts of the 'social question'. For Eucken social justice was not a countervailing political target *vis-à-vis* a competitive order – it was rather the most natural consequence of a competitive order. He argues (1952/90: 317, my translation) that 'social justice should be produced . . . mainly through submitting the creation of incomes to the strict rules of competition, risk, and liability'. And Böhm (e.g. 1966/89) early foresaw legal problems created by the tension between a classical liberal *Rechtsstaat* or protective state and a politicised welfare state (*Sozialstaat*).
5. For more detailed information see, for example the early warnings of Streit (1991) or Sinn (1992) and first retrospects by the IWH (2001); Schüller/Weber (1998) or Mummert/Wohlgemuth (eds, 1998).
6. Fiscal transfers to East Germany from 1990 to 1999 amount to some 1795 billion DM (918 billion euros); the biggest part being transfers to social security systems and employment substitutes. Net transfers (after taxes) per East German household totalled some 200 000 DM. In 1999, transfers amounted to one-third of East Germany's GDP (OECD 2001: 11).
7. For most firms private 'owners' were still lacking when the first wage settlements were negotiated. State officials had to represent future owners' interests, which they did with understandable nonchalance.
8. GDP per capita in the new states stagnates at around 60 per cent of the level in the western states (OECD 2001: 11).
9. For more detailed discussions on these issues see, e.g., Streit/Mussler (1994); Woolcock (1994); Gowan/Anderson (eds, 1997); Vanberg (1993; 2000); Siebert (ed., 1997); Scharpf (1999); Moser/Schneider/Kirchgässner (eds, 2000).
10. See Streit/Mussler (1994); Gerken (ed. 1995) and Sally (1998, chs. 7 and 9) for more details.
11. Decentralisation and competition are not only discovery procedures in view of *existing* needs and alternatives, but also in view of *changing* structures of preferences and problem situations. Hayek's critique of homogeneous goods as a condition for 'perfect' competition can easily be translated into an argument concerning harmonised institutions: 'because of the ever changing character of our needs and our knowledge, or the infinite variety of human skills and capacities, the ideal state cannot be one requiring an identical character of large numbers of products and services' (Hayek 1946/80: 104).
12. By assuming stable and known preferences of representative citizens and politicians as omniscient and benevolent dictators, welfare economists most naturally tend to endorse fiscal harmonisation or centralisation (e.g. Sinn 1994; 1997).

13. For a more thorough discussion of the legal and political matters involved, see e.g. Siedentop (2000); Meyer (1999); Héritier (1999); Schlesinger (1999); Laffan (1998); Majone (1988); Marks/Scharpf/Schmitter/Streek (eds, 1996); Scharpf (1999).
14. There are fairly effective European networks of interest groups and rent-seekers. Precisely the lack of European public political discourse and the ensuing ignorance of votes concerning the pork-barrel going on in Brussels offer formidable opportunities for distributive coalitions to attain privileges at European consumers' and taxpayers' expense. European agricultural policy is only the most striking case.
15. See Nye/Donahue (eds, 2000); Held (1995) for more thorough discussions.
16. International comparisons of direct investment statistics suffer from serious methodological problems. But the figures still illustrate a trend: according to German balance of payment statistics foreign direct investment in Germany between 1984 and 1994 totalled 34.6 billion DM; at the same time German firms invested 166 billion abroad. And according to the German ministry of economic affairs, German firms created 3.4 million jobs abroad, while foreign firms only created 1.5 million jobs in Germany.
17. Thirty years ago German unemployment rates were about one-fifth of the US rate which was about the same it is today. But today German unemployment is roughly twice that of the US rate. In addition, overall employment rates are lower and unemployment periods are longer in Germany compared to the USA (Heckman, 2001).
18. See for example, Giersch/Paqué/Schmieding (1992); Siebert (1997); Ljungquist/Sargent (1998); Heckman (2001). In terms of statutory income and corporate tax, a tax reform bill became effective in 2001 (phased over a 5-year horizon) that will place Germany in the middle range of OECD tax burdens, down from the group with highest rates (OECD, 2001: 7). In terms of business regulation, Heckman (2001: 17) observes that 'compared to the US, German firms are required to go through more procedures (7 vs. 4) and take a longer time (90 vs. 7 days) and which cost roughly ten times more in Germany than in the US'. Employment protection laws are also stricter than OECD average – which in combination with rigid collectively determined wage-structures reduces job growth in response to GDP growth and increases structural unemployment of unskilled labour. Finally, codetermination laws require a number of union officials or shop stewards elected to the board of directors by employees. This number depends on industry and firm size. In the coal and steel industries, this number must equal the number of board members elected by stockholders. The present government has extended codetermination requirements to smaller firms (with more than 200 staff) thus increasing non-wage labour costs since labour representatives remain on the pay-roll but are released from their original job assignments.
19. For a more detailed analysis of the effects and a public choice explanation of *Sozialpolitik* in Germany, see for example Vaubel (1991). The damaging influence of vested interests on the political and economic order is discussed by Mitchell/Simmons (1994); Streit (1987); Tollisson (1982) and Olson (1982).
20. Germany being a representative democracy, it has almost always seen party coalitions with often precarious majorities backing government. This may also contribute to policies marked by compromise, myopia and symbolic policy.
21. Recent surveys show that 25 per cent of Germans expect that globalisation is disadvantageous for Germany; 21 per cent expect advantages and 43 per cent have mixed feelings; 54 per cent fear that world-wide competition will increase Germany's unemployment (Bundesverband Deutscher Banken, 2000).

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8. Regional retreat: the reaction of Russian institutions to liberalising reform

Richard E. Ericson

INTRODUCTION

Integration into the global economy poses particularly sharp difficulties for Russia, as it is also coping with a radical transformation of its economic system. The Russian economy is emerging from a system thoroughly incompatible with the modern market economy that is now emerging at the global level. Processes of globalisation stand in sharp contradiction to the inherited, and still struggling new, institutions of the Russian economic system. This had led much of the economy to resist, and even reject, changes required to allow effective integration into the world economic system. This resistance has been particularly strong and visible at the regional level and outside the cosmopolitan centres. Despite increasing pressure toward globalisation from the Russian federal government, domestic institutions are resisting change with the idea of protecting the Russian people, even though that implies growing isolation and an increasing gap between world and Russian average standards of living.

To integrate effectively into the global economy, to 'globalise' politically, economically and socially, Russia has to move much further, undergo far greater change, than any other country with a developed industrial base. Russia finds itself in this position as the largest remnant, the core, of the former Soviet Union, struggling to emerge from the structures and constraints of that system. As the prototype and canonical example of the only complete, and one time functioning, industrial alternative to modern market capitalism, the Soviet Union developed an extensive and coherent system of institutions, political and economic agents, and networks of interaction and activity built around principles fundamentally incompatible with, and indeed destructive of, the operation of a market economy, be it national or global.[1]

The processes of both liberalising reform and globalisation enhance opportunities for economic agents and factors by removing barriers to choice and mobility. But in doing so, they necessarily constrain the actions of governments by offering agents an 'exit option' so that governments must pay attention to agents' incentives and desires. Thus governmental units are forced into competition, with their ability to grant privileges and/or extract rents limited, together with their ability to deal with externalities. Thus these processes, when allowed full play, can be damaging to the powers and prerogatives of political authorities, particularly when they are, as in the former Soviet Union, accustomed to the ability to command and control all political, social and economic processes within their purview.

Processes of globalisation operate directly on and through markets, enhancing both their flexibility and volatility, and hence often putting severe strain on their supporting institutions. Indeed, the benefits of globalisation and liberalisation depend critically on the ability of institutions to facilitate participation through appropriate adaptation. Where appropriate institutions are nonexistent, or existing institutions dysfunctional and inflexible, the strain can lead to a breakdown of functional market relations and to socially damaging opportunistic behaviour by market participants. Thus there is a need for substantial development of market institutions, and serious strengthening of their resilience in the face of global shocks, for integration into the global economy to bring the promised benefits. It is precisely the underdevelopment and even absence of these institutions that has led Russia, particularly at the regional and local level, to resist global influences and, in many instances, to retreat from market reforms.

In this chapter I want to explore the logic of this development, highlighting the ways in which the uncertainties in outcomes and shocks to prevailing élites have stimulated distortions of, and even retreat from, market reforms despite strong pressures from the political centre. After characterising the resulting situations, I conclude with an exploration of the meaning and possible consequences of the new politically centralising thrust of the Putin regime and its 'liberal' economic policies. They may be signalling the beginning of a successful evolution to a truly marketised economy, one that is capable of benefiting from the changes of growing global interdependence through markets. Or they may be masking the retreat to a more *dirigiste* protectionist economic system, valuing economic and social stability above global integration and change.

THE SOVIET SYSTEM AND GLOBAL PRESSURES

The Soviet society, polity and economy were singularly closed to global pressures and developments. Despite the growing penetration of global influences, particularly in the cultural sphere during the era of *détente*, the global processes of technological and economic change, and of development of institutions supporting and regulating complex market interaction, largely bypassed the Soviet Union. This naturally led to a growing structural isolation and backwardness of the economy, and a decline in its ability to meet the needs and desires of the Soviet people and state. That decline fostered an increasingly urgent search for 'improving and perfecting' the socialist economic mechanism, thus hopefully allowing the system to realise its full potential and surpass the capitalist world.[2]

This search became all the more urgent as the Soviet economy throughout the 1960s and 1970s was subject to growing influence and pressure from the global economy. Foremost was the growing pressure from the increasingly successful competitive example of developed capitalism. Growing consumer, and indeed worker, wealth and agricultural surpluses in the West contrasted with agricultural failure and slowing consumption growth in the Soviet Union. This challenged the ideological foundations of the Soviet claim to economic superiority, and raised the pressure to increase performance, to find effective policies and/or reforms in order to surpass clearly the capitalist West. One apparent solution involved an opening to the outside world to increase strategically determined trade, acquiring new technologies and some critical consumables, financed by exports of energy and raw materials, and of basic industrial materials that the Soviet Union was capable of producing in large quantities.

This strategic turn, driven in part by the need to deal with the consequences of serious crop failures, coincided with highly favourable, for the Soviet Union, developments in the world economy in the 1960s and 1970s. These included a rise in raw materials' and energy prices, built on the strong and growing global economy, as well as cartelisation of supply (e.g. OPEC), that gave a substantial boost to Soviet macroeconomic performance in the 1970s. This policy, however, led to a growing dependence on the outside world, both for the import of consumables and technology, and for the ability to export energy and raw materials to finance those imports.

The improvement in macroeconomic performance, however, proved passing, and somewhat illusory, coming as it did at the cost of increasing dependence on the world economy for imports of food, advanced technology, and high-value consumables, and for earnings from exports of energy, materials and armaments. It furthermore did nothing to improve the efficiency of the economy or to slow the growth of economic

and technological obsolescence, i.e. of the technology gap with the West, and hence brought increasing pressure from the global economy for change in the Soviet system. And this pressure had direct implications for the all-important military and strategic competition with the West, and for the Soviet leadership's faith in the ability of the Soviet system to ensure its survival and success.

These growing pre-globalisation pressures led the Soviet leadership into a never-ending search for improvement in the functioning of the Soviet economic system, for reforms that would ignite the creative and productive potential of socialism, leading to a victory in the competition of world systems. Thus the Soviet Union pursued a continual series of reforms, starting with Khrushchev's *Sovnarkhoz* decentralising experiments (1957–64), through Brezhnev and Kosygin's recentralisation and decentralising 'treadmill of reforms' (1965–79) and Andropov's 'large scale industrial experiments' (1983–4), to Gorbachev's *Perestroika* and radical economic reform (1987–91).[3] None of these provided more than a temporary respite from the inexorable decline in relative economic performance, with the failure of each attempt leading to a radicalisation in the next. In every attempt but the last, the Soviet economic system successfully reasserted its coherence, undermining and emasculating the reforms and forcing their reversal, re-reform or abandonment. Only when the new first Secretary of the CPSU, Mikhail Gorbachev, moved to truly fundamental reforms, attacking the roots of the political–economic system and its institutional foundations, was the Soviet system unable to maintain its coherence and ability to survive.

The Soviet isolation from the global economy, together with the Soviet economic system, collapsed dramatically during the brief but intense period of *Perestroika* (1987–91) and Gaidar's (1992) so-called 'shock therapy', making the obsolescence and failures of the Soviet economy painfully obvious, although without providing any effective short-run solution to its manifest problems. This radical opening coincided with the 'collateral damage' of the disappearance of the Soviet Union and the emergence of a separate Russian economy.[4] Under the leadership of Boris Yeltsin, Russia launched an ambitious attempt to build a globally integrated market economy on the foundations and ruins of the Soviet economic system.[5]

Formal economic policy focused on jump-starting a 'normal' European economy through radical decentralisation, marketisation and rapid integration into the global economic system. It hoped to activate market forces through trade and price liberalisation, monetary stabilisation and budgetary restraint, and the massive transfer of productive property from state to non-state (private) hands. This radical reform programme was launched

with decrees eliminating most price controls and most administrative/regulatory powers of the economic ministries, while permitting free entry by all into any trading activity, both domestic and foreign.[6] It envisioned an extension and deepening of liberalising measures, evolving together with the growth of market forces.[7] But that was not to be, as economic and political élites rapidly coalesced into a functional opposition that stalled, distorted and blocked implementation, often leaving the shell of reform in place but without its necessary institutional and economic content.[8]

The initial result was an explosive growth of trade, solving the immediate (winter 1991–2) urban food and fuel crises, and a sharp drop in production activity in the face of extreme uncertainty from rapid change in the economic environment, including the loss of almost all guidance from (now eliminated or eviscerated) superior organs. However, rather than signalling the beginning of serious behavioural and institutional change, and a market-oriented restructuring of production and trade, this 'shock' triggered a defensive reaction, a pulling-back from necessary, painful stabilisation measures and structural reforms and the creation of networks of mutual support among the economic and political agents that continue to protect inherited political and economic structures and élites.[9] While most mechanisms of social support and employment were allowed to decay into dysfunction, those with access to and control over valuable political and economic resources were able to generate protected spheres for themselves, allowing reform waves to break around them while siphoning rents and wealth from the remains of Soviet structures which they controlled.[10] Thus the longer term result has been a continuing struggle between the forces of marketisation and global integration embedded in some federal structures and successful business operations, and the inherited structures and institutions from the Soviet system, firmly entrenched at the regional and local levels, resisting that alien intrusion in their struggle for survival.

CONSEQUENCES OF RADICAL ECONOMIC REFORM

Radical economic reform under Yeltsin focused first of all on breaking the formal institutions of the Soviet economy, and secondly on a radical opening of the economy to inside and outside competition. The consequences of these reforms, as in all transition economies, have been largely unintended, arising from the interplay of numerous factors. In Russia these comprised political, organisational and legal changes imposed by reformers from above, structural constraints imposed by geography, history and the development path followed by the Soviet Union, the self-interested

exploitation of the preceding by those who were able, and the struggle to avoid change and harm by many of the economic and political agents empowered by the previous system.

Despite the radical deconstruction of Soviet formal institutions, the informal institutions giving them content largely survived. Networks of personal connections and economic interaction, ways of managing organisations and doing business, and the Soviet understanding of how an economy does and should work remained largely unaltered in the wake of radical reform. Paternalistic, collectivist informal understandings and structures remained under an élite, largely liberated from formal constraints, but often motivated by an 'obligation of position' inherited from Soviet understanding, as well as by the pursuit of personal power and wealth. Further, the breaking of formal institutions fostered a rapid political decentralisation and retreat from control by Federal authorities seeking to prevent further breakup by urging regional authorities to 'take all the sovereignty you can swallow' while remaining in the Federation.[11]

The fundamental fact behind most of the response to radical reform was the widespread, inherent non-viability, in a market economic sense, of many, and in numerous regions, most economic enterprises and operations. While the wide-ranging, but far from complete, liberalisations that accompanied the Gaidar reforms opened tremendous opportunities for some, they thus posed a threat to the vitality, and indeed survival, of many other agents, organisations and structures that the Russian economy inherited from the Soviet Union. In particular, much, if not most, of the inherited capital stock, including human capital, was rendered potentially valueless, indeed fully dispensable, in the new market configuration of activity and values.[12] Those economic agents containing and/or controlling these assets, and in particular those whose human capital, training and skills were substantially devalued on the coalescing market, had every incentive to resist the change, and to obstruct the implementation and functioning of new market mechanisms that failed to recognise their perceived inherent value. And they had every incentive to cooperate among themselves, to build supporting networks and to activate political and personal capital and connections in order to secure resources that would allow them to survive without succumbing to outside factors and influences.

These economic agents had powerful allies in regional and local leaderships who were also struggling to maintain their relevance and power in the supposedly changing, democratising political environment.[13] Both groups were coming from the Soviet élite, the *nomenklatura* and its offspring, and both had reason to fear displacement by new, qualitatively different agents and forces in the turmoil and uncertainty of the changing political and economic environment. With much to lose, and only highly uncertain

prospects of any gain, this élite naturally turned toward slowing, stalling and/or controlling the processes of change, so that those processes became no longer threatening, and perhaps even became supportive of the maintenance of that élite's power and privilege.

Those particularly hard-hit by the reforms included most of the 'commanding heights' of the Soviet socialist economy, much of whose product was obsolete and/or of low quality. In particular, the military industrial, engineering, and manufacturing sectors, and those involving the advanced processing of materials proved vulnerable, and shrank significantly as sales vanished in the 1990s. Consumer durables and processed foods production declined even more precipitously as their products were subject to stiff foreign competition following the opening of the economy to trade. And the combination of the loss of substantial state subsidies and the loss of markets to imports dealt a serious blow to agriculture, which remained substantially collectivised despite a formal allocation of land to households. Each of the entities in these categories suffered sharp drops in activity, output and earnings, threatening the well being of their managers, workers, and the population and politicians of the regions in which they were located.[14]

On the other hand, opening markets both internally and to the world economy suddenly offered vast new opportunities for those with access to materials and products for which there was an active market. Producers of raw materials, basic metals and chemicals, oil and gas, and holders of substantial inventories of industrial inputs were able to prosper by selling at world prices far above the 'costs' (in bizarre Soviet prices) at which those materials were acquired, extracted, or produced.[15] Those with political, foreign or criminal connections giving them access to the right markets, and the intermediaries facilitating such access, were able to acquire vast wealth rapidly in the turmoil of the early reform, often by exploiting the inflexibilities, controls and/or barriers to trade left by the incompleteness of the reforms adopted.[16] And in doing so, they frequently disrupted old, previously planned, interactions on which the activity of industrial firms depended for inputs, thus aggravating the collapse in output and earning of those industrial firms and the regions in which they were located.[17]

This damage acquired a sharper political edge due to the Soviet concentration of industrial activity in relatively few large firms, and the planning-driven geographic concentration of different branches of industry.[18] Thus the collapse of demand and breakdown of production had clear, large and concentrated social and economic costs, which urban and regional political leaders could not ignore. This was particularly the case in heavily industrialised regions, not focused on the extraction and primary processing of energy resources and raw materials, and in agricultural regions not closely

tied to relatively prosperous urban centres. In these cases the livelihood and even survival of large groups of people was cast into doubt by the clear non-viability of the core economic activities in these areas. A strong dynamic response was called for, changes in the nature and structure of economic activity and interaction that would render the underlying talents and assets of the region economically valuable in the new economic environment. The reform leadership in Moscow was hoping for such a response, one facilitating mobility and reallocation of labour, capital and resources as well as the fundamental restructuring of all economic institutions and activity.

That, however, has not been the response of most political and economic leaders at the operational and regional levels, at least to the end of the twentieth century. Élites, released from constraints of party, ideology, and the police power of the state, took advantage of the opportunities presented by the reforms to secure their personal positions and wealth.[19] Rather than facilitating new initiative and entrepreneurship, supporting the reallocation of resources and assets to those with new approaches and capabilities, they seized all they could as privatised property, and used it to extract rents. Investment and even maintenance expenditures collapsed, as assets were exploited to extract any possible immediate surplus. And substantial subsidies were sought and received, increasingly indirectly as 'directed credits' and loans, to maintain employment and the functioning of increasingly obsolete industrial objects. This added to the growing disparities in the incidence of the consequences of the reforms, as those areas or firms with political clout and/or a readily saleable product (e.g. oil) prosper relatively, while most of industry and most of the country sink ever further into obsolescence and poverty, with decaying capital and infrastructure and a configuration of economic activities ever less likely to become viable in a fully marketised environment.

VARIETIES OF REGIONAL AND INSTITUTIONAL RESPONSE

The radical policies of removing the formal economic institutions of the Soviet Union, of liberalisation and privatisation in the face of widespread non-viability, threatened a breakdown of all old ties and relations, without providing current élites clear alternatives for survival. Instead, they opened opportunities for 'outsiders', including 'criminal groups', foreigners and/or Moscow 'investors', to move in, to seize control and reallocate assets or restructure operations in their own interests. This naturally created a 'crisis of legitimacy', stimulating local and regional economic and political élites

to reassert their old bases, to rebuild Soviet networks and recombine in new ones, in order to stave off collapse, to maintain a semblance, albeit at a lower level of activity, of the old order production, exchange and consumption. By maintaining the apparent viability of old structures, this response blocked effective restructuring and hence any improvement in the fundamental efficiency and productivity of the local substantive economy. Thus despite strong central policies specifically aimed at integration into the international economy and society, at the 'globalisation' and 'normalisation' of Russian society and economy, many of the social, political and economic institutions inherited from the Soviet era resisted the implied changes, and often successfully.[20]

This, of course, depended to a large extent on the political leadership of regions and localities, which varied in its attitude from enthusiastic embrace, through tepid acceptance to outright hostility and irreconcilable rejection of the new economic and social directions. This can be seen in the wide variation in the implementation of regional reforms, and the growing resistance to marketisation in many of the regions. While some places such as Nizhny Novgorod, Novogord, Samara and St Petersburg pushed forward on the full federal marketising reform package, most others deferred or increasingly obstructed liberalising measures. In most regions the prices of basic consumables remained controlled, supported by local subsidies and police powers, with Ul'yanovsk for example continuing rationing until mid 1996. Over 69 per cent of goods and services prices remained controlled in Orel in 1997, and about a third in Bashkortostan, Mordova, Amur and Astrakhan.[21] Similarly, large-scale privatisation was blocked until regional élites were able to secure the 'second method' allowing them as 'insiders' to retain control over the enterprises in their regions, while their control over small-scale privatisation allowed it to develop rapidly, although even here a number of regions lagged, with Ul'yanovsk only beginning auctions in June 1997.[22]

Most regions pursued policies of local regulation and taxation that actively impeded the development of new small businesses, particularly those that would compete with existing entitles from which 'rents/protection' were being collected. We see business entry restrictions, residency restrictions, and licensing requirements to maintain operations, and health/sanitation, fire and safety inspection used to limit competition. And frequently, investors or entrepreneurs from outside are required to take on local 'partners' to receive the appropriate approvals to do business in the area. Thus after rapid growth from nothing (pre-perestroika) to some 900 000 in 1994/5, the number of small businesses shrank through 1998, before showing a recovery to about the same number in 1999–2001. While about a third of all enterprises in Russia could be classified as small,

the share varied widely across regions, ranging from some 10 per cent in the north Caucasus, Tuva, Kursk and Pskov, to about 50 per cent in Krasnoyarsk, Leningrad and Tyumen.[23]

Regions and cities have also successfully resisted central reform pressure with respect to subsidisation of inefficient industry, with Moscow and Tatarstan taking the lead in rescuing, for example, failing automobile plants, and joining many others in 'renationalising' many industrial enterprises in lieu of tax payments to prevent their bankruptcy. Among other examples, Belgorod has taken over its iron ore combine, Sverdlovsk Oblast has taken a stake in Alkar Aluminum, Krasnoyarsk has bought into the Krasnoyarsky Metallurgichesky Zavod, Kursk has taken equity in Mikhailovsky Iron Works, Tatarstan has bought into Tatneft Oil, and Samara into AvtoVaz. St Petersburg and Sverdlovsk, among other regions, are taking controlling interests in their leading regional banks, and Sverdlovsk is taking a 25 per cent share in Nizhnii Tagil Metal in exchange for restructuring the company's tax and wage arrears.[24]

Finally, the regions and cities have taken active control over the privatisation of land and other real estate, with some such as St Petersburg, Saratov and Samara allowing open purchase, sale and resale, but most regions blocking anything beyond leasing. It should be noted that this control over real estate provides the source of much of the wealth and power of local and regional governments through both control over enterprise activity and the ability to extract revenues.[25]

This varied response to reform has led to a patchwork of liberalisations and constraints that has seriously impeded the formation of a general market environment. Indeed, markets have remained fragmented, regionalised and localised, as political authorities have imposed barriers to imports and exports of products, protecting the population's standard of living, the profits of local enterprises and hence the rents to be extracted from them, and finally the power of political élite to control economic activity. Many regions like Ul'yanovsk maintained restrictions and licensing requirements on trade (movement of goods) across regional/political boundaries, and the number of such anti-integrating regions increased following the August 1998 crisis.[26] This has led to a varying degree of domestic market integration across regions and over time, creating a substantial barrier to any globalisation impact, with a clear group of non-integrating regions forming a 'red belt' across the heart of Russia in the mid to late 1990s.[27] Further, the performance implications, the costs, of these regional variations in integration and reform implementation are partially compensated by federal fiscal policy, which validates the differences through 'equalising' federal transfers, supporting the regional status quo.[28] Further, federal funds assigned for support of social programmes and federal operations in the region were

frequently reassigned to purposes the local or regional leadership found more important, such as supporting favoured local industry or paying for energy or oil inputs in the region.

To a large extent, these policy responses have been a consequence of the fundamental non-viability of much industrial enterprise in the regions, and the threat that posed to the wellbeing and stability of the region in a market environment. In addition to the widespread erection of protective barriers against both internal (regional/municipal) and external competition noted above, we see an extensive implicit subsidisation of industry through the acceptance of non-payments and arrears of taxes, and the use of non-monetised transactions through barter, *vekseli*, and offsets at localised, idiosyncratic prices. This protection from outside influences has also been supported in a number of areas by the introduction of local script as a substitute for money in transactions, effectively cutting the region's economic interaction with the outside.[29] Among other common practices to protect inherited economic structures were the provision of local amenities (housing, nice offices, bonuses, etc.) to control federal officials, the use of special local rules on documentation, registration, and language use, and the continuation of the Soviet practice of 'telephone' administration and justice; all at the discretion of the local boss. This generates a particularised 'local/regional' legal regime, in which one needs to work outside a formal, verifiable contractual framework, trust only 'insiders', and rely on connections, personal contacts in the region, to get things done. These policies allowed maintaining much of the local substantive economy in operation, despite price and demand shocks from liberalisation and the relative non-viability of parts of the local economy.[30]

Coupled with continuing price controls and guidelines for price changes (no more than x per cent markups), the requirement to supply 'necessary' operations even without payment, and to accept non-monetary payment for goods and services rendered, this creates a system of economic relations hardly conducive to marketisation or globalisation of economic activity. The result was rather an extensive 'virtual economy', appearing larger and more viable than it actually was, that supports a configuration of activities and interactions that could not survive in a truly marketised environment, but continue to maintain the underlying structure and logic of prior Soviet economic development.[31] This further fragmented markets, both directly and through undermining the uniform means of exchange, reducing competition that might threaten local business and hence the pressure to restructure both production activity and institutions.

These policies also facilitated the 're-demonetisation' of economic activity and interacting outside of retailing, finance, and foreign trade.[32] It involves a general 'flight from the ruble' in both savings ('dollarisation') and

intermediation (barter), and in tax payments ('offsets'), particularly in the large enterprise sector. It derives from a high degree of uncertainty with respect to both economic and political policy, the lack of legal protections ('rule of law') and property rights, the weaknesses and inefficiency of the banking system, and the rapacious nature of taxation, involving arbitrary and unpredictable confiscations unless the 'right relations' are established with many different levels of authorities, both public and private. Demonetisation is particularly driven by the governments' Soviet-like use of banks as tax collectors and enforcers, giving economic agents a strong incentive to avoid the use of banks and money whenever possible. It also facilitates the maintenance of traditional (Soviet) networks and relations, as transactions can be arbitrarily and differently valued by different parties in the absence of a uniform currency measuring stick; it avoids the need for strict market 'equivalence of value' in exchanges.

Finally, this demonetisation effectively undercuts the development of factor markets, particularly for labour, by tying resources to current uses and avoiding fungible money that would give factors mobility. Thus, while local labour markets are rather free and flexible, the inherited Soviet industrial structure ensures that local opportunities for labour redeployment are rather limited. Labour, while formally free to move, is tied to its (inherited) place of work by social services, including housing and medical care, provided by the enterprise, locally enforced residency and registration requirements, and growing wage arrears.[33] This tie is reinforced by the lack of any other generalised social support mechanisms. Thus the labour market is localised, revolving around second jobs ('fiddling'), self-employment, and criminal activity.

The weakness of critical factor markets is one of the primary reasons, together with the predatory behaviour of political and criminal (mafia) authorities, for the lack of new entrepreneurship and small business growth in Russia. New enterprise is either controlled, or fought, by such 'authorities'.[34] Only if one has the right connections, is politically tied in, can one engage in new enterprise, in the 'recombination of factors'. Where pre-existing and politically powerful institutions/enterprises operate, it is extremely difficult to enter unless one has the political clout to take control of those institutions. Thus we see most successful new enterprise in areas where there were no, or only seriously underdeveloped, Soviet institutions – banking, finance, trade and services. And even here, control is rapidly asserted by local or regional 'authorities', either official or criminal.

Even where marketising reform was accepted by the leadership, the underlying institutional framework and structure of economic activity has proved strongly resistant to change, reacting defensively to protect themselves, and local populations, by rejecting the alien implantation, the

imposition of new institutions, norms and patterns of behaviour. The radical opening of the Soviet economy, and even more so its systemic demise, pushed existing élites and institutions to assume a defensive posture, and resist the new globalised processes of exchange that radical economic reform was attempting to establish. Although new laws were adopted, formal institutions were changed, forced to adapt to new objectives and procedures, they retained much of their 'Sovietised' character, of the evolved essence of interaction from the prior period. That is to say, the informal institutions that stand behind and give content to formal structures did not immediately adjust, and hence rejected much of the essence and impact of globalisation, of marketising reform, instead falling back on traditional, Soviet-based, industrial and economic networks and the quasi-autocratic local substantive economies in many of the regions.

This process of decentralised resistance to liberalisation and the principles of the global economy was facilitated by the deep political decentralisation that Yeltsin fostered ('take as much sovereignty as you can swallow'), and by the collapse of central and integrative political structures that followed the disintegration of the Soviet Union and its Communist Party. Regional and local élites seized power with alacrity, some for marketising and integrating with global economic processes, but most for purposes of protecting themselves, their power and privilege, and their populations from the risks of serious economic change. After an initial period of democratic and electoral ferment, in which some new leaders rose to the surface, regional and local business élites consolidated, sometimes into two opposing political camps, fundamentally differing only in how they would distribute the 'rents' to political power. In most regions the current ruling group of political and business élites consolidated control after the regional and local elections of 1996–7, and has maintained control in most regions despite some changes of governor. This has consolidated a near feudal structure of personalised power and connections giving regional and local leaders an autonomy that approached near sovereignty in several (largely national republic) cases prior to Putin's recent moves to centralise power.

Thus, as Darrell Slider (1997, pp. 445 and 457) has argued, 'Market institutions have emerged in Russia's provinces in spite of, rather than because of, the political decentralisation that has occurred in Russia since the collapse of communism'. Rather, market and other 'globalising' forces have been held at bay by Russia's 'market-distorting federalism' that gave regional élites 'substantial powers to determine economic policies and shape institutions' in an incentive environment not 'conducive to the development of free markets, market institutions, competition and investment'. That incentive environment is derived in large part from the inherited market non-viability of most formal economic structures and institutions

inherited from the Soviet Union, as well as from the inherited informal institutions and implicit understandings of economic life. Because of the difficulties those posed, the threat to the wellbeing of élites that reform promised, the system instead replicated many of the non-market characteristics of the Soviet system in its idiosyncratic bargaining over resources, powers and privileges and its authoritarian behavioural response to disruption and unanticipated change (*stikhiinost*). This, together with the survival of the Soviet Party/*nomenklatura* élite, led to the regional and local shaping of economic systems that substantially deviated from the national reform (liberalising) model/objective.

CONCLUSION: AN EVOLUTIONARY SOLUTION?

This situation means that Russia has to move much further and faster than most economies to even begin integrating into the global economic system. As we have argued, the difficulty of that move has led Russia in many ways, and in many regions, to reject it. Hence, although progress has been mixed, the primary phenomenon to 2001 has been a defensive retreat and retrenchment from the shock of radical reform.

This has occurred despite the strong dependence of current stability and normality on the export of resources and energy to the world economy. Much like the Soviet economy of the 1970s, the present appearance of relative prosperity depends on the surplus produced by selling resources to the world, while protecting domestic producers and workers through structural impediments to global entry into the domestic economy, if not to imports of goods whose price is high due to an undervalued ruble. The favourable configuration of international resource prices and currency valuations is, however, now dissipating as the ruble undergoes real appreciation and the world economy sinks into a recession, threatening Russia with an even more severe depression unless it can adjust to the changing economic environment.

But internal institutions, particularly at the regional level, have yet to adjust sufficiently to work effectively, to be competitive and thrive, in a truly globalised environment. Rather, they have turned to non-market political and economic measures and interactions to shore up existing structures, to compensate for the shocks from outside influences, rather than learning from and adjusting to them. Inefficient economic operations and structures are supported, rather than restructured or removed, and successful operations are forced to transfer surpluses to the inefficient, providing them with an incentive to hide or export their earnings. Hence, while initial costs of adjustment are avoided, deepening long-run costs are incurred, costs of

ever growing needs for subsidisation and compensation, impossible to satisfy given the inefficiency of inherited structures, and costs of the widening gap in productivity and wealth differences with the marketised world. This places the Russian leadership and élites under increasing pressure to do something more, to begin serious restructuring of institutions, infrastructure and production activity in order to respond adequately to globalising pressures and to maintain Russia's position in the world. Thus the apparent stability of the current system appears ephemeral.

While the federal government, and Putin himself, appear to recognise this, there is a real question about their ability to bring fundamental, marketising change. Slider (1997) argues that the Russian federal government has had few instruments to check arbitrary and illegitimate use of local power, and that still seems the case even with Putin's new supergovernors and his new right to remove elected governors for malfeasance and/or violation of the law. Thus the institutional and procedural certainty required for markets to function properly cannot be assured; rule of law depends on the discretion of the authorities at each administrative level. While the central authorities can politically enforce a small number of central priorities, most implementing behaviour must be channelled through existing institutions with their embedded incentives. Such institutions are generally not supportive of transparent market interaction in Russia, leaving much economic activity subject to the arbitrary discretion of regional and local élites. Although the 'crown' is strengthening under Putin, the 'lords and nobles' of the post-Soviet system retain much of their power, position, prestige, influence and wealth, even if there has been some change in their composition.

Despite this, Putin, by exercising charisma and selective intervention with police powers, has been able to ride a wave of favourable shocks toward apparently greater integration into the global economic system. The sharp devaluation of the ruble in 1998–9, the rise in energy and resource prices, Russia's central position in the US 'war on Terrorism', and its pivotal position in the world energy markets, when coupled with firm control over external debt and breaking the economic grip of the financial oligarchy on the federal government, created an economic environment within Russia conducive to recovery and marketising economic development. The rise in the value of exports and the devaluation-imposed increase in the cost of imports stimulated domestic demand and remonetisation of the economy, while devaluation and default destroyed the oligarch's financial pyramids built on manipulating and exploiting state finances. As the possibility of extracting rents from the state evaporated, it became necessary for business to focus on the bottom line, on providing real goods and services for monetised demand, instead of relying on governmental favours for survival.

In addition, Putin has moved vigorously to crush the appearance of any serious political, and in particular business, opposition, effectively removing those not already reduced by business failure from political influence.[35] Further, Putin's regime has pursued enforcement of uniformity of laws, their simplification and application to all (except perhaps the Presidential Administration) uniformly, and substantial liberalisation and simplification of regulation, again uniformly enforced across regions.[36] While implementation has not been entirely successful, this has still facilitated the rise of a new group of successful entrepreneurs, replacing most of the old oligarchs, who are increasingly investing in restructuring and developing new business in Russia instead of exporting their earnings.[37] All of this has fostered new local incentives for entrepreneurship and market based growth.

Thus a new economic situation has begun to form, opening a real possibility for global economic integration. As Berkowitz and DeJong (2001b) have demonstrated, domestic markets are growing more integrated as regional and municipal barriers to trade have lowered, in part from federal efforts to impose uniformity in laws and regulations. Further, with the decline in the power of Moscow-based finance, big regionally based businesses, largely in the resource and energy sectors, have become more important and expanded beyond their home regions. They are exercising their not small political clout to limit local and regional government predation and barriers to marketisation. Since the crisis of 1998, a number of large conglomerates have formed, expanding beyond their core resource, energy and banking operations to engineering, telecoms, trade and even agricultural business.

Three new conglomerates in particular stand out as attracting the attention and interest of international capital. The youngest, Millhouse Capital, was formed by a merger of Sibneft (oil) and RosAl (aluminium), has holdings in a dozen different sectors ranging from insurance, through pulp and paper processing and electricity generation, to ground and air transportation, and contributes some 4 per cent to Russian GDP. Potanin's Interros has now expanded well beyond its banking and *Norilsk Nikel'* roots to encompass oil, bread, jet engine and steel production, and grain trading, contributing some 3 per cent of Russia's GDP. And the Alfa Group has expanded beyond its trading and banking roots to now include oil drilling and processing, aluminium, cement and steel pipe manufacturing, insurance, retailing and telecoms, producing perhaps 5 per cent of Russia's GDP.[38] This diversification has been a major source of new investment in restructuring of industry in Russia over the past year, and a major impetus toward integration of Russia's regions, both prerequisites of effective global integration. These new businesses have also been significant in pushing Russian business in general toward accepting application for membership

in the WTO, opposed for natural reasons by the leadership of many of the regions and of the old enterprises inherited from the Soviet Union.[39]

These favourable structural trends, and their associated macroeconomic recovery and growth, have thus arisen from the conjunction of a favourable international economic environment and the pursuit of economic liberalising policies by the Putin regime. The former has weakened the resistance of the regions and surviving institutions by substantially lowering the cost of adjustment – 'a rising tide lifts all boats' – while the latter has stimulated and rewarded new initiative and entrepreneurship. The economy has responded by recovering solidly from the 1996–8 depths of economic depression, but that recovery has been rather narrowly based, driven by import substitution and the exploitation of natural resources. The mass of firms in the core manufacturing sectors, despite early 1999–2000 gains from restarting existing capacities, almost all of agriculture, and indeed most of rural Russia, remain mired in deep depression, and are only weakly affected by the new opportunities and incentives. It is these enterprises (firms, farms, and collectives) that must be brought into the sphere of marketised growth, be reformed and restructured to enable flexible response to the changing opportunities and pitfalls that the global economy presents, for the processes of globalisation to succeed in, and bring benefit to, Russia.

Thus the question arises: are the current incentives and opportunities for market-based growth sufficient? The obstacles are truly enormous. Capacities and technologies are obsolete, infrastructure has crumbled, and political and administrative organs continue to prey on business activity that they do not control, unless the business firm is too strong and has higher political protection.[40] The banking system and financial intermediation remain unreformed and improperly regulated. Fiscal federalism, and the systems of taxation and governmental expenditure, despite improvement over the past two years, remain areas of political conflict and confusion of law and implementation. Tax and fiscal systems still penalise economic success and implicitly support failure, perverting incentives for marketisation.[41] And small business, despite recent declarative efforts by the Putin administration, remains an object of exploitation for municipal and regional governments, who still protect their rents by restricting entry and competition in local markets. The fear of competition and distrust of 'outsiders' still runs deep, even though there is growing recognition of the need for outside financing. Finally, there is a growing integration of 'big business' and local and regional governments that ties the success of one to the success of the other, providing each with an incentive to block entry and competition, and hence the possibilities for further economic integration.[42]

To get around these obstacles will take time. Firms will need to find the will and means to restructure, to focus on profitability rather than the

maintenance of relations. The centre will have to succeed in its drive to enforce legal uniformity, equal protection and rights for both insiders and outsiders. And that includes protection from the government itself, from its administrative, police, and regulatory authorities. In particular, business will need to secure respect from the local, regional and federal authorities for its property, if it is to be secure enough to invest, to explore market opportunities and to respond to challenges posed by the global marketplace. Indeed, all this, and more, will be necessary for effective WTO accession.

Such a transformation of the economic and political environment can be expected to stimulate a burst of investment activity and new entrepreneurship, particularly in light of the vast opportunities presented by the undevelopment and maldevelopment of the economy inherited from the Soviet Union. This activity would be directed toward the fundamental restructuring and rebuilding of Russian industry, going well beyond the recent agglomeration and diversification by cash-rich exporting conglomerates. Through both forward and backward linkages it should stimulate ever widening and deepening circles of economic and business renewal, providing a growing basis for a viable, flexible market system that is truly open to the advantages of globalisation. And it should be emphasised that Russia could potentially benefit more than most from globalisation and its 'gains to trade', because of its highly uneven and specialised endowments or resources, and of human and physical capital.[43]

Such developments will, however, inevitably take much time. It requires the development of a 'virtuous circle/spiral' of interaction between evolving market business practice and the learning by governmental organs that prospering, competitive and flexible business is the basis of local prosperity and political stability. Both business and government must learn to respect and trust each other within the bounds of true rule of law, with local and regional governments in particular retreating from the commanding heights of business influence toward a market-supporting role as referee and facilitator. And the central government must learn to restrain itself, perhaps through development of an appropriate division and balancing of powers, to a role of facilitator, referee and adjudicator among subordinate governments and economic entities. It needs a firm but light hand, restraining without directing, and upholding the uniform and transparent application of liberal law that allows the experimentation necessary for the evolution of a fully market system to occur.

Clearly, such a positive evolution is not inevitable. Much depends on the objectives and intentions of the Russian central leadership, the degree to which they are actually implemented, and how they interact with accidents of economic development over time. The current drive to strengthen central power, the 'administrative vertical', to rein in the regions and

suppress the oligarchs, and to limit overt political opposition, can provide the capability to pursue liberal, marketising reform as Putin proclaims and we have generally accepted above. It can, however, also go too far, and may reflect the early stages of an 'economic security regime' with targeted reindustrialisation and government orchestrated investment and financing of economic development.[44] While eliminating overt internal barriers to trade and market interaction, such a policy would undermine the proper functioning of markets, severely damaging their informational properties that are so important in view of the massive structural changes needed in the Russian economy and the vast uncertainties about how to implement them.

Such an approach would stifle decentralised market experimentation, initiative, and both success and failure that characterise the proper functioning of a market economic system. The state could be strengthened, and indeed much industrial activity revived, but in ways obstructive of market initiative and activity, dramatically reducing the flexibility needed to deal with and in the global economy. Such a retreat to a more *dirigiste*, and ultimately protectionist economic system, would raise from the regional to the national level the protection of economic and social groups threatened by global integration and change. And it would surely deny Russia the benefits of integration into the global economy and market system.

NOTES

1. The nature, characteristics and principles behind the Soviet economic system are studied in Ericson (1991).
2. See the discussion in Ericson (1990).
3. The 'treadmill of reforms' is analysed in Schroeder (1979, 1983), while the origins and objectives of economic *perestroika* are studied in Ericson (1989).
4. The Soviet Union was effectively eliminated as a result of the Belovesh agreement on 8 December, 1991, between the heads of the Russian, Belorussian and Ukrainian Republics (Boris Yeltsin, Stanislav Shushkevich and Leonid Kravchuk, respectively) creating the Commonwealth of Independent States (CIS). They were rapidly followed out of the USSR and into the CIS by first Kazakhstan, and then the other Central Asian and Caucasian Republics. See, among others, Aslund, Garnett and Olcutt (1999).
5. The most complete discussion can be found in Aslund (1995).
6. Following Yeltsin's January decree freeing all forms of trade, small kiosks, flea-markets and street trading sprang up throughout Russia. See Aslund (1995).
7. This is clear in the 'Medium-Term Programme for the Development of the Russian Federation' adopted by the Yeltsin–Gaidar government in April, and presented to the IMF in June, 1992.
8. The advances and retreats in the reformers' efforts to change the economic system are outlined in Aslund (1995), and given depth and a personal perspective in Gaidar (1996).
9. This is the heart of 'Russia's Virtual Economy' analysed in Gaddy and Ickes (2002).
10. The roots and logic of this are analysed in Hedlund (1999) and Hough (2001).
11. Yeltsin made this statement in Kazan on 5 August, 1990, while on a trip rallying Russian regions' support for his struggle against Gorbachev and, ultimately, the Soviet Union.

12. This argument is made more fully in Ericson (1999) where the impact of Soviet pricing on the structure and viability of Soviet sectors is analysed.
13. They were subject to particular danger of replacement in the early period under the uncertainties and turbulence of the new electoral systems. But by 1997, local élites had firmly re-established control, absorbing new members who had risen in that turbulence and stabilising the local political situation by effectively blocking new outsiders, sometimes even when those had Kremlin support. An excellent source for the evolution of the power and prospects of the regional and local élites is the EWI *Russian Regional Report*, published weekly since 1996.
14. Particularly hard hit were the engineering (machine-building and metal working), food processing, coal, and textile industries, and most enterprises of the defence industries together with the partially abandoned closed cities/regions (ZATOs) in which they were often located.
15. The coal industry is a glaring exception to the viability of extractive resource industries. It was an extremely inefficient but essential part of the Soviet industrial structure. Most coal enterprises cannot cover costs and should be shut down, and indeed the World Bank has provided over $5 billion to facilitate that shutdown and ensuing relocation of workers. The process has been extremely slow due to resistance and obstruction by the local and regional authorities.
16. Massive fortunes were made in the early transition by arbitraging the irrationalities of the insufficiently liberalised price system. This is the source of much of the wealth of the early 'biznesmeny' and of much rent-seeking by bureaucrats and politicians since. See I. Bunin (1994) on the early 'biznesmeny' and Aslund (1995, 2001) for discussion and further references on rent extraction.
17. This effect is given a clean theoretical analysis in Blanchard and Kremer (1997), and is empirically explored in the case of the Ukraine by Kaufmann, Gorochowski and Marin (2000).
18. This was in part a consequence of Soviet misunderstanding (exaggeration) of the returns to agglomeration and scale, leading to industrial 'giantism', the absence of small, flexible enterprises, and the excessive regional concentration of object in the same industry branch. It also arose as it facilitated the processes of central planning and allocation of material and capital inputs by simplifying the task and allowing more easily controllable delegation. On the structure and concentration of enterprise that Russia inherited from the Soviet Union, see the World Bank study of Brown, Ickes and Ryterman (1993).
19. Hedlund (1999) discusses these and other behavioural distortions that arose from the collapse of Soviet constraints.
20. The success of this resistance to the end of the 1990's raises the question of whether Yeltsin's Russia should be considered to have a market economy. The subject is addressed in Ericson (2001), from which some of the subsequent discussion is drawn. Also see Sutela (1998).
21. *Preminiimatel'skii klimat regionov Rossii* (Moscow: Nachala Press, 1997).
22. While over 85 per cent of all small enterprises were privatised by the beginning of 1997, all the national republics had privatised (sometimes substantially) less than half of their small enterprises. For example: Kabardino–Balkaria privatised only 20.3 per cent; North Ossetia, 24.5 per cent; Sakha, 37.3 per cent; Mari-El, 43.5; Tatarstan, 47.4 per cent. For an analysis of the strategies and compromises in the privatisation programme in Russia see Boycko, Shleifer and Vishny (1995).
23. Data can be seen in various years of Goskomstat Rossii, *Rossiiskii Statisicheskii Ezhegodnik*, Moscow, in particular 1998, 2000.
24. See *Izvestiia* (1997) and *RFE/RL Newsline* (1998). The *EWI Regional Report*, Vol. 4 noted further takeovers in 1999 in Ul'ianovsk (#3), Krasnoyarsk (#4), Voronezh (#10), Moscow (#11, #14), Primorye (#13), Sverdlovsk (#14) and Chel'iabinsk (#15). Further examples of 'velvet privatisation' can be found in Kryshtanovskaya (2002).
25. See Shleifer (1997) and Slider (1997).

26. In December 1998, Krasnoyarsk and Kemerova regions joined Tatarstan, Altai, and the Volgograd region in introducing new restrictions on food trade and grain transportation (*Moscow Times*, 1998). On earlier actions see S. Krayukhin, T. Zil'ber (1998).
27. This market integration phenomenon is analysed econometrically by Berkowitz and DeJong (1999, 2001, 2002). The barriers to trade, and the non-integrated 'Red Belt', seem to be fading during the recovery under Putin.
28. See the working paper by Popov (1999) and the work of Treisman (1998).
29. For example, the script used in lieu of wages by a roadbuilding company in Chelyabinks, *dorozhniki*, were used widely in 1999, while Ponazyrevskii district of Kostroma Oblast' has been using a locally printed 'money card' for the past 3 years. On the latter, see C. Kenneth, 'Village uses an unorthodox currency in its economy', *The Russia Journal*, 25–31 January.
30. The logic of, and need for, this protection is argued in Woodruff (1999) in his case studies of Samara, Krasnoyarsk and Primore. He particularly clearly discusses the role of local/regional governments in protecting local economies from transformational shock through facilitating 'barter of the bankrupt' and supporting use of local quasi-monies and barter to ensure survival of local businesses. This is the environment that provides the basis for the 'virtual economy' studied by Gaddy and Ickes (2002). Also see Ericson (2001).
31. The origins, structure and functioning of this economic subsystem, or set of segmented subsystems, of the Russian economy is analysed in the monograph of Gaddy and Ickes (2002).
32. Enterprise transactions in the Soviet Union were essentially demonetised, and that again became the case in much of basic Russian industry in the mid to late 1990s. See for example, Ickes, Murrell and Ryterman (1997) and Aukutsionek (1998).
33. See the analysis of Friebel and Guriev (2000).
34. The best recent discussion of new small business in Russia is Aslund (1997). For evidence on the political problems of small business in Ul'ianovsk see the *IEW Regional Report*, Vol. 4, #3 and #10.
35. While Gusinsky and Berezovsky are the most prominent among these, many others, including Vakhirov and Aksyonenko, at *Gazprom* and the railroad ministry respectively, have also recently been removed. Again see the discussion in Kryshtanovskaya (2002).
36. This was outlined in the medium-term Gref Program in July 2000, and its progress repeatedly analysed by both Gref and Putin since then. See V. Putin, 'Annual Address to the Federal Assembly', on Russian TV, 11am, 3 April, 2001, reproduced in JRL #5185, 3 April, 2001, for the primary directions being pursued in 2001. The original Gref Program, published 15 July, 2000, is available on the www.kommersant.ru website. The state of the programme and current tasks had earlier been elaborated in a press briefing by German Gref, Minister for Economic Development and Trade, on 2 March, 2001. See www.fednews.ru for that date.
37. Capital flight fell to $10–12 billion in 2001 from $25–30 billion in 1999–2000. The new entrepreneurs and oligarchs have been studied, on the basis of survey research by Academy of Sciences sociologist Olga Kryshtanovskaya, in a series of articles in January and February 2002 in the journal *Vremya MN*. See Kryshtanovkaya (2002).
38. For an introduction to these, see V. Korchagina et al. (2001), p. 1.
39. Agriculture and industries as diverse as aircraft, furniture and textile manufacture and confectionary products have expressed fear and opposition. See for example the articles in the weekly *Ekspert* (2001, 2002).
40. For a careful study of nine core sectors of the Russian economy analysing these and other problems, see the *McKinsey Global Institute Report on Russian Economic Performance* study of Russian industry in 1999. It can be found at http://mckinsey.com/mgi.html.
41. For just one small example, investment is taxed as profit, rather than being considered an economic cost to be deducted.

42. For a nice discussion of the (not so) recent conflation of government and business, see Kryshtanovskaya (2002).
43. Specialisation of assets, endowments and capabilities always enhances the gains to interaction and trade. One of the most damaging aspects of Soviet development policy was its pursuit of autharchy, made particularly costly by the unevenness of its natural and man-made endowments.
44. This seems to be the thrust behind each of the two recent proposals, apparently encouraged by Putin, of economic programmes to replace the current liberal programme of German Gref. These are contained in the 'Ishaev Report' (2000) and the Security Council's 'State Strategy for National Economic Security' proposed in mid 2001. See J. Tannenbaum (2001) and A. Nadzharov (2001).

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9. Institutional deterrents to the empowerment of women: Kenya's experience

Tabitha W. Kiriti, Clem Tisdell and Kartik C. Roy

INTRODUCTION

Male domination, perceived as embedded in cultural norms and institutions, characterises intra-household power relations and resource allocation patterns. Institutional mechanisms and sets of beliefs play crucial roles in keeping 'undesirable' changes invisible, thus maintaining the sex stratification system intact. Gender empowerment has been recognised as a key improvement in the empowerment of women in developing countries. Developing the ability to organise and influence the direction of social change, to create a more just social and economic order nationally and internationally, can enhance women's empowerment. However, institutional factors act as deterrents to women's empowerment not only in Kenya but also in many developing countries. Women tend to suffer from these institutional impediments more than men, and among women, rural women suffer more than urban women. In this chapter we show that both domestic institutions and society act as deterrents to the empowerment of women. Although structural adjustment, globalisation, agricultural and product pricing reforms and other reforms have opened opportunities for the educated and professional women, they have intensified the existing inequalities and insecurities to which poor women are subject. These reforms have been implemented without corresponding reforms in institutions, thus enhancing the marginalisation of women and their lack of empowerment.

INSTITUTIONS

The term institution is a set of humanly devised behavioural rules that govern and shape the interactions of human beings, in part by helping them

to form expectations of what other people will do. It applies to organisations such as government departments that have defined structure and resources, and to tangible customs, decision-making procedures, laws and codes of practice (Pearce, 1993). Institutions are the humanly devised constraints that shape human interaction (North, 1990). They define and limit the choices of individuals and reduce uncertainty by providing a structure to everyday life. Institutions are therefore a guide to human interaction, so when we want to name our children, perform weddings, bury the dead, relate with adults or children and so on, we know or can easily learn how to perform these tasks (Mlay, 1996).

Institutions may be formal such as laws that human beings devise, or informal such as conventions and codes of behaviour. They may be created, as in constitutions, or they may simply evolve over time like the common law. Institutional constraints include both prohibiting individuals from undertaking certain activities and under what conditions. Institutions are therefore a framework within which human interaction takes place. They play a critical role in aiding the resolution of disputes and determining what is or is not socially acceptable (Pearce, 1993). The major role of institutions is to reduce uncertainty by providing a stable (though not necessarily efficient) structure to human interaction (North, 1990).

Institutional reform is a complicated process in that the changes at the margin can be the consequence of changes in the rules, in informal constraints, and in the forms and effectiveness of enforcement. Also, institutional reform is typically incremental rather than continuous (Mlay, 1996). How and why these reforms take place is the result of the indebtedness of informal constraints in societies. Formal rules may change overnight as a result of political or judicial decisions but informal constraints embodied in customs, traditions and codes of conduct are much more impervious to deliberate policies. These natural constraints not only connect the past with the present and future but also provide us with a key to explaining the path of historical change. Consequently, institutional reform is a vital prerequisite for the empowerment of women. In the context of this chapter, institutional reform entails reform in government institutions and the informal rules of people that are embodied in their customs, traditions and codes of conduct as they affect the economic and social life of women and men.

Institutions determine the position of each individual member. These institutions could be domestic institutions like the household, or the society at large. The institutions that we could include under the banner of society range from education institutions, employment institutions, judiciary, decision-making institutions such as parliament or local authority, financial institutions, health institutions and so on. The determinants of the ability of these institutions to adapt to social and economic changes can be best

examined within a theoretical framework of a social and sex stratification model, supplemented by the conflict theory of family dynamics.

The sex stratification system ranks one gender, almost always the male gender, higher than the other and determines that only they will occupy major decision-making positions and will control the valued resources in society. Such valued resources cover a wide range such as: wealth, income, credit, knowledge (in terms of literacy, education and information), technology, valued skills, valued income-generating activities, food, health, power and prestige. The norms and set of values embedded in a particular culture bring with them entitlements or rights ascribed to certain categories of persons to particular shares, often related to basic subsistence needs, such as food and clothing. The way in which these institutions confer power to some members based on age and gender differences, reflects the norms of distributional justice of the group or society. An individual is therefore subject to socially determined valuation that becomes internalised through a socialisation process. Early socialisation practices emphasise the primary role of women as mothers and wives and influence girls' total expectations for future participation in the labour force and their choice of career paths.

Male domination, perceived as embedded in cultural norms and institutions, characterises intra-household power relations and resource allocation patterns. Women see men as authority figures whose decisions they are to follow (Roy and Tisdell, 1993a; Saito, 1992a,b). The sex stratification system is supported by laws and policies that spell out and legitimise men's privileged and dominant status and is justified by religious, traditional, moral, and/or pseudo-scientific ideologies and beliefs.

Sex stratification is institutionalised and pervasive and is maintained and supported by widespread institutional mechanisms and sets of beliefs. The more scarce the valued resources, the more the patterns of allocating these resources represent 'rational' investment strategies that are thought to maximise the short- and long-term survival chances of the institution (that is, society or household).

The pervasiveness of a powerful sex stratification system, coupled with an equally powerful social stratification system, is responsible for the fact that such national investment strategies are usually male-biased. At the societal level, traditional patriarchal values assign to men the economic responsibility for women and children. Men are thus given priority over women in terms of preferential access to paid employment, income-generating productive activities, and credit, in addition to better education and training opportunities, hence reducing the future empowerment of women.

Sex stratification also determines the flexibility or rigidity of society, community or household experiences in the face of important social and economic changes. Institutional mechanisms and sets of beliefs play crucial

roles in keeping 'undesirable' changes invisible, therefore maintaining the sex stratification system intact (Safilios-Rothschild, 1988). The sex stratification system relies on the premise that women are economically dependent on men. The increased prevalence of female-headed households in many developing countries has been viewed as a challenge to this basic premise and as a threat to the very fabric of patriarchal society since it indicates that husbands no longer play a dominant role in the family and thus goes against the established sex-stratified order. Women's income also plays a crucial role in the dynamics of intra-household allocation of resources. However, despite the crucial role that women's income plays for family survival, husbands do not usually acknowledge the size and importance of this income. Acknowledgment would constitute an admission of the husband's inadequacy as a breadwinner, and would tend to undermine his unquestioned dominance (Safilios-Rothschild, 1988).

Within the context of a powerful and pervasive sex stratification system, men cannot adapt to social and economic changes that significantly increase women's access to income, the key resource. Instead, under these circumstances, they usually resort to mechanisms that neutralise the impact of ongoing changes, and thus, preserve the sex stratification status quo. They may resort to force and violence or they may become more domineering, authoritarian, repressive and violent at home than before in order to ensure that the integrity of the existing patriarchal power structure is not in any way challenged by women's changing status.

Divorce is the limiting factor in this type of marital conflict. The degree of social acceptability of divorce, the probability of remarriage for women, and the viability of female-headed households which in turn is determined by access to significant income earning opportunities, further conditions the domestic institution's degree of rigidity or adaptability.

These institutions, justified by traditional moral ideologies and religious beliefs, enhance gender inequality and act as a deterrent to the empowerment of women.

EMPOWERMENT OF WOMEN

Gender empowerment has been recognised as a key improvement in the empowerment of women in developing countries. Women's empowerment includes:

1. acquiring knowledge and understanding of gender relations and ways in which these relations may be changed. This can be achieved mainly through the reduction of gender inequality in education levels, increased

literacy of women and removal of the old curricula that stereotype women as only mothers and wives;
2. developing a sense of self-worth, a belief in one's ability to secure desired changes and the right to control one's life. Apart from enabling women to acquire higher levels of education, there is need for reform in the domestic, political and other institutions that have been discriminating against women. Making it easier for women to dissolve non-working marriages, control their fertility, acquire property rights, and so on, can also help women gain a sense of self-worth;
3. gaining the ability to generate choices and exercise bargaining power. By acknowledging women's output as an important contribution in the society, as well as acknowledging that women's income is not a threat to men, then the bargaining position of women can be enhanced starting from the household level to higher decision-making institutions like parliament.

Developing the ability to organise and influence the direction of social change to create a more just social and economic order nationally and internationally can enhance women's empowerment. Inequalities between women and men are deeply rooted and need to be tackled across the board in economic, political, social and cultural life. Getting girls through school is essential but education is not enough. Progress in education is dependent on the success of tackling wider and deeper causes of inequality, especially reforming the social–cultural institutions that act as deterrents to women's empowerment.

THE IMPACT OF INSTITUTIONS ON WOMEN'S EMPOWERMENT

Women are the vehicles of development in Africa although institutional impediments prevent them from realising their full potential in the pursuit of development goals. Women are underrepresented in industry, in commercial agriculture, and in the service sector. They are overrepresented in subsistence agriculture, and in the informal service sector. As housewives, women perform multiple roles of looking after the family, as subsistence farmers, traders as well as working wage earners in commercial agriculture. They are the major victims of environmental degradation and technological change has rendered many women unemployed, as men with the help of machines now perform many of the tasks previously performed by women. The impediments that women face translate themselves into a lack of access to valuable resources, lack of property rights, lack of access to

appropriate technology, higher poverty rates, low literacy rates, under-representation in decision-making institutions, reduced life expectancy, low enrolment ratios in learning institutions, low GDP per capita, low in terms of the Human Development Index, the Gender Development Index and the Gender Empowerment Measure.

ACCESS TO VALUABLE RESOURCES

Men's control over labour in Africa as a factor of production translates into claims on women's labour for cultivation of the husband's fields. In effect, the culturally determined rules of access to and control over resources may constrain women as much as external biases in providing access to farm support services. The cultural norms may actually predetermine unequal access to agricultural inputs, marketing services, and farmers' organisations because of the link between farm support services and land title, for which women are rarely eligible.

Access to and control over productive resources are also a function of social status, which can be ascribed or achieved. Most formal and legal rights to land have been given to men, while women only have user rights to some of the land. This may affect their productivity because of lack of security. Women in Kenya do not inherit land, which means that they depend on their male relatives both when it comes to land distribution and decisions about farming. If a woman chooses to remain unmarried, is divorced or widowed, she does not have any rights to land and will be in a very exposed situation. This lack of security and access to land means women cannot undertake large investments.

The World Bank (1996) says that women and children are more vulnerable because tradition gives them less decision-making power and less control over assets than men. At the same time, their opportunities to engage in remunerative activities, and therefore to acquire their own assets, are more limited, hence lack of empowerment.

PROPERTY RIGHTS

Bromley (1991) defines property rights as a claim of owners to benefit streams that the state will agree to protect from others who may covet, or somehow interfere with the benefit stream. Furubotn and Pejovich (1974) define property rights as the sanctioned behavioural relations among men that arise from the existence of goods and pertain to their use. These relations specify the norms of behaviour with respect to goods that each and

every person must observe in his daily interactions with other persons, or bear the cost of non-observance. Tietenberg (1992) suggests that an efficient structure of property rights could produce efficient allocation of resources. Property rights should be universal, exclusive, transferable and enforceable.

Women have never been involved in land distribution and this means that they have been excluded from the new legal approach in land ownership. They have neither legal access to land nor sufficient money to acquire it, because they have almost no income. In many African countries, Kenya included, land adjudication and registration meant that land previously held by custom, and over which simple use rights prevailed, became the object of property rights. This made women's situation worse because land titles belong to men and they have all the rights to transfer the land to whomever they want and also they have entitlement to the proceeds that come out of the land. Land rights go to the male heirs while the daughters are almost entirely excluded. This also means that women lack property rights and security of tenure. Security of tenure is especially important to women, given their lower socioeconomic status and limited access to productive and valuable resources and services, and lack of it has enhanced their lack of empowerment. Lack of property rights has also made it difficult for women farmers to access extension services and formal credit. Lack of collateral, transaction cost, long distances, limited education and unfamiliarity with banking procedures all increase their opportunity cost.

Women's agriculture is therefore carried out within the confines of powerful and limiting constraints. Compared with men, women are disadvantaged in their access to and control of a wide range of assets. With fewer assets and more precarious claims to assets, women are more risk-averse, more vulnerable, have a weaker bargaining position within the household, and consequently are less in a position to respond to economic opportunities. Access to land and other productive resources are critical in creating wealth and generating growth. The right mix of assets, for example land, labour and financial services are critical to ensure that women are not 'investment poor' and are economically empowered.

ACCESS TO APPROPRIATE TECHNOLOGY

Women's access to new agricultural technology is limited. Technologies appropriate for the activities, farming objectives and production conditions for women are lacking. They overlook the requirements of women. The inadequate supply of suitable labour and energy saving farm and household technologies for women's activities impairs their productivity. This is

because technology is mainly male-oriented, such as heavy machinery, tractors, ploughs and so on. Women use such crude implements as hoes, pangas, and cutlasses and so on, which are very slow and labour-intensive. Lack of title or secure tenure and access to small dispersed and remote plots are strong disincentives to adopting new agricultural techniques. Diseconomies of scale not only reduce women's yields but also cause extension agents to dismiss women as non-adopters of new technologies (Roy and Tisdell, 1993b).

In addition, technical inputs and agricultural extension services, promoted by transnational and national donor agencies in the post-independence period to increase production among smallholders, have continued to favour male rather than female producers (Staudt, 1982). When new agricultural technologies are introduced, women are bypassed in training, credit extension and land reform programmes. Extension agents tend to be men who deal with male clients. One may assume wrongly that an increase in family income arising from cash crop production will lead to an increase in women's income. In some societies in rural Kenya, males take possession of any cash income earned by females, or most of it, and use it for their own ends. This has enhanced women's low socio-economic status and lack of empowerment.

HIGH LEVELS OF POVERTY

Women and men experience poverty differently, and different aspects of poverty (deprivation, powerlessness, vulnerability, its seasonality) have gender dimensions. Vulnerability reflects the dynamic nature of poverty such as defencelessness, insecurity and exposure to risk. The more assets people have, the less vulnerable they are. Assets include stores, concrete productive investments, human investments, collective assets and claims on others for assistance. Women and children are more vulnerable because tradition usually gives them less decision-making power over assets than men, while at the same time their opportunities to engage in remunerated activities, and therefore to acquire their own assets, are more limited (World Bank, 1996).

Women bear a significant responsibility for the family's subsistence. In virtually all societies, women are the main carers in a family and they are often willing to sacrifice their own welfare for the benefit of other family members, especially their children (Tisdell, 1999). In many countries, they are also important economic providers for the family giving considerable economic support to their children. But their capacity to fulfil this responsibility has been significantly affected by lack of economic empowerment

caused by such factors as unequal sharing of household resources, unequal access to earning opportunities to agricultural land and by the decline in common property resources and forests (Roy and Tisdell, 1993a).

Women are generally immobile because of greater responsibilities for childcare, household provisioning, doing household chores and other home-based agricultural activities. Agricultural extension officers, who are mainly male, discriminate against them and this results in women using outdated methods of cultivation, leading to low yields and hence low income, which translates to poverty and continued lack of empowerment. The cultural norms are such that women find it hard to venture out to look for work or to mix with men in certain traditions. This prevents them from gathering information on job opportunities. They are cut off from channels of communication, or the information they receive is filtered through the (male) head of household or community leaders. Tisdell, (2000) observes that since the welfare of children is highly dependent on the welfare of their mother, the deprivation of females results in deprivation of children.

LOW EDUCATION AND LITERACY LEVELS

Education is one way of empowering women. The gender gap in primary and secondary school enrolments is measured as the ratio of female to male enrolment at each level times 100. These two are measures of women's status as far as education in early years is concerned. Where places in school are limited and resources are scarce, girls are at a particular disadvantage. Parents may prefer to educate sons, both because expected benefits are higher due to better job prospects for sons and dependence on sons in old age, and costs are lower because of the low opportunity cost of their time in terms of help in the household.

Adult literacy rates are largely a reflection of historical trends in primary school enrolment. A higher gender gap is a reflection of women's lower status since literacy is the forerunner of empowerment due to a host of expanded opportunities for women including earning power, control over health and child-bearing, political and legal rights and so on. There existed a gender gap in adult literacy in Kenya of well over 15 per cent in both 1995 and 1997, since the female adult literacy rates were 70.02 per cent and 71.8 per cent for 1995 and 1997 respectively compared to 86.3 per cent and 86.9 per cent for males. However, in the primary and secondary levels the enrolments are almost equal. This shows that a large percentage of girls do not make it to tertiary level, reducing their chances of better opportunities in employment and earning power and therefore creating a lack of empowerment.

LOW FEMALE/MALE RATIOS IN DECISION-MAKING INSTITUTIONS

Participation of women in decision-making institutions is a mark of empowerment. The UNDP in its Human Development Reports uses this as one of the indicators of gender empowerment. The effectiveness of Africa's development efforts and the ability to sustain them are dependent on the full utilisation of all human resources (both men and women). Yet there is a continued underutilisation of women who constitute slightly over 50 per cent of the population in Africa. Most socioeconomic indicators show that women are disadvantaged compared to men. The vast majority of Africa's women find their total livelihood within agriculture and the informal sector. The majority of women in formal sector employment are concentrated in semi-skilled and non-skilled jobs that are also low paying.

Women's representation in technical and professional fields is still limited. Their representation in decisionmaking positions is also extremely limited. There are various reasons that account for this situation. First, early socialisation practices emphasise the primary role of women as mothers and wives and influence girls' total expectations for future participation in the labour force and the choice of clear career paths. Second, women's overall limited educational attainment as well as the types of curricula used in schools that emphasise stereotypic roles for women create further barriers. Career guidance and counselling likewise tend to channel girls into traditional female fields such as nursing and home economics. Third, women's multiple responsibilities as mothers, wives, employees and employers create role conflicts that at times could result in compromises in careers. Women's careers tend to be interrupted during their childbearing years, resulting in loss of seniority. In addition, as women are usually expected to move with their husbands, the interrupted career syndrome further compromises their career progression. Fourth, organisational policies and procedures are often influenced by cultural perceptions of women's roles and capabilities. This leads to women being discriminated against in recruitment, promotion to senior positions and benefits as it is assumed that women lack the qualities essential for successful managerial careers.

Women's level of participation at all levels of decisionmaking is low. In parliament, the highest level of decisionmaking, women are underrepresented. Most women in high government positions in Kenya are in such ministries as education, culture, social welfare, women's affairs and so on. Women rarely achieve elective office, and are severely under-represented at top positions in political parties. Women are also under-represented at the local authority level and as heads of institutions.

This shows that despite the fact that most governments have adopted and adapted affirmative action measures and the rhetoric of gender balance, the figures still indicate that, even though women make up more than half of the population, they are represented in far less than half of the decision-making structures. The threshold of 30 per cent advocated by the UNDP *Human Development Report* (1997), as a prelude to the 50 per cent, is still a dream for most women.

DECLINING LIFE EXPECTANCY

Life expectancy is one of the human development indicators. There is a very strong relationship between national health care spending and life expectancy. Considering that most African governments have reduced their expenditures on almost all sectors due to pressure from the World Bank and the IMF, this implies that life expectancy in most African countries is going to decline.

Kenya started implementing structural adjustment programmes in 1994, which meant reduced government expenditure in such sectors as health, education, transport, social services and so on. This has meant shifting the cost of consultation and drugs to households. Considering the already low incomes, most sick people avoid going to medical facilities, thereby raising the mortality rate. This has resulted in a decline in the life expectancy rate for both male and females. AIDS-related illnesses have also taken their toll and contributed to a reduction in life expectancy. HIV/AIDS is the fourth most common cause of death worldwide. Women experience a double burden as a result of the spread of HIV/AIDS; a burden of suffering and a burden of caring for those who are suffering, as is expected of them. In Kenya, 49 per cent of those with HIV/AIDS are women. Of the adult population, 11.64 per cent have HIV/AIDS, and women have the extra burden of caring for this population.

In Kenya, the life expectancy differential was only three years in 1995 and it fell to two years in 1997. A small differential or higher male life expectancy indicates a gender gap in health status (that is, women's lower status *vis-à-vis* men).

FEMALE SHARE OF PAID EMPLOYMENT IN INDUSTRY AND SERVICES

The UN indicator framework selected women's share of paid employment in industry and services as the indicator to track the progress towards

gender equality in employment. It signals the extent to which obstacles to women working in unpaid jobs in family enterprises is crumbling. In Kenya, the female share in paid employment was 32 per cent in the year 2000, which was an increase from 20 per cent in 1980 (UNIFEM, 2000). This was a result of the increased globalisation of trade and the establishment of Export Processing Zones (EPZs) in Kenya providing casual labour for women. However, women's entry into waged and salaried work in industry and services does not necessarily mean that they escape subordination within their families. In most cases the income that a woman earns may act as a threat to the man since it shows that he is no longer in a position to provide for his family and he may become violent, controlling or even take the woman's earnings to use for his own purposes. This means that though women are entering paid employment, they still remain helpless in the face of outdated cultural norms and practices.

GENDER-RELATED DEVELOPMENT INDEX (GDI)

In 1995, the UNDP launched two new measures to track progress in tackling inequalities between women and men. These were the Gender-related Development Index (GDI) and the Gender Empowerment Measure (GEM). These measures have been used every year to assess the progress of nations towards the elimination of inequality. However, since they were launched in 1995, the GDI and the GEM have shown that significant progress in closing gaps has been achieved in the last quarter of the twentieth century. However, all human development reports state that in no society do women fare as well as men; while there has been a closing of gender gaps in human development, there is still a long way to go in sharing political and economic opportunities; women continue to suffer high levels of violence and abuse; and lastly many countries continue to discriminate against women in law.

GENDER EMPOWERMENT MEASURE (GEM)

The Gender Empowerment Measure (GEM) measures the extent to which there is gender equity in economic and political power. It thus attempts to measure not only achievement in wellbeing but also equity in agency. The GEM uses variables constructed explicitly to measure the relative empowerment of women and men in political and economic spheres of activity. It thus attempts to measure gender equity in participation in governmental and managerial decision-making, professional roles, and economic

activities generally. However, the UN does not have GEM value for most developing countries due to non-availability of data and therefore these countries are not ranked.

VIOLENCE AGAINST WOMEN

The most shocking manifestation of women's inequality is violence. Women cannot always depend on justice systems to protect them from violence. In most countries, Kenya included, wife beating is not regarded as an offence and couples will most probably be advised to sort out their problems quietly. It is only when one of them dies (in most cases the woman) that the authorities start investigations. In Kenya, it was not until December 2000 that wife beating was declared an offence. However, without proper sensitivity and education about their rights, women will continue to accept wife beating as part of their lives.

INSTITUTIONS AND GLOBALISATION

Globalisation is a process or a condition whereby producers and investors increasingly behave as if the world economy consisted of a single market and production area with regional or national sub-sectors, rather than a set of national economies linked by trade and investment flows. Globalisation is the move towards a global economy where national borders cease to matter and this has changed the face of the world. Globalisation is said to offer economic growth and prosperity to people around the world. It creates new options; new avenues for trade in goods and services, as well as new opportunities for capital investment and the allocation of mobile resources.

Globalisation and the resulting competition impose restrictions on the freedom of action of national governments, especially in the provision of certain public goods. Although Vanberg (1999) says that however understandable the desire for a safeguard against market risks may be, it cannot be satisfied in a manner still desirable if extended to all parties in a non-discriminatory manner. He says that a re-distributive regime that can genuinely claim to serve the interests of all citizens would have to pass a minimal test that it is capable of extending equal treatment to all parties involved in a non-discriminating, privilege-free manner. However, even if redistribution schemes that grant privileges to some at the expense of others can hardly be sustained under conditions of competition, there is no reason why privilege-free schemes for social insurance could not be organised in ways that enable them to be viable under such conditions

(Vanberg, 1999). This is especially true for those societies that already have gender inequality and it is important to cushion the women and children who would be especially hard hit by the effects of globalisation. This can be done in the form of subsidies, tax benefits or other preferential treatment, which are granted in a discretionary and discriminating manner to women and other vulnerable groups. This therefore means that before we blame globalisation, we should first reform the already existing institutions to make them compatible with globalisation.

It is true that certain people have benefited from the new opportunities provided by globalisation. However, there are many people in the world, especially women, who have not been able to enjoy the benefits of globalisation. This is because globalisation has not been able to facilitate the process of reforms of political institutions, bureaucracies, judiciaries and social safety nets.

The move by large numbers of women to paid employment from traditional, invisible work (that is, work not taken into account in official calculations) has taken place against the background of increasing globalisation, and women have experienced both its opportunities and its threats. The economic independence that these jobs provide has for the first time given African women the ability to contribute to their families financially, the ability to delay marriages and child-bearing, and even the means to end oppressive marital relationships.

However, the price for this economic freedom can be high. In many cases, women continue to earn lower wages than men performing the same work, and opportunities for training and promotion are typically kept to a minimum. Secondly, due to the socialisation process, a working woman may not enjoy or even bargain for any authority in decision-making as this poses a threat to the already established norm that men are the breadwinners. The husband may take the earnings and use it for his own purposes (Kiriti et al., 2003).

Much of the new employment generated by globalisation of the economy is poorly paid and carried out in highly exploitative conditions. Work is often of a temporary, casual type, and consequently without the health, safety, and social security benefits that more stable employment may ensure (Kabubo and Kiriti, 2000). Although women have found employment in the manufacturing sector, the majority of women are found in the informal sector, rural farming communities and in subsistence economic activities. The shifts in production patterns due to globalisation have led to the dislocation of women from their traditional sources of livelihood, thus enhancing their lack of empowerment.

Market-oriented reforms require social safety nets to prevent people from falling through the cracks (Rodrik, 1997). Globalisation requires

strong institutions and in the absence of such institutions, globalisation is likely to foster domestic social conflicts which are not only damaging in their own right, but are also detrimental to economic growth in the long run (Rodrik, 1997).

Globalisation should be underpinned with a supportive legal, regulatory and political apparatus. Reforms have paid too little attention to mechanisms of social insurance and to safety nets.

INSTITUTIONS AND STRUCTURAL ADJUSTMENT PROGRAMMES

The process of structural adjustment relies on the re-allocation of resources between sectors. Women are less likely than men to own or have access to productive resources and are often less able to reallocate the few resources they have. Thus, women are more likely than men to be spectators, rather than players, in the adjustment process. In rural areas, male farmers benefit directly from policies that favour cash crop production but indirectly, women may suffer as demand for their unpaid labour intensifies. Although overall household income may increase, women's control over decisionmaking in the household may be reduced. In urban areas, men are more likely than women to lose jobs in public sector retrenchments given that men are more represented in the formal labour force. The fall in household income when men lose jobs may compel women to increase their market work, hence increasing their burden (Hilary, 1999).

Apart from this, job losses result from the drive for higher efficiency in order to be competitive in the global market, and also from the introduction of technology to raise productivity. These job losses have fallen heavily on unskilled workers, mainly women. Most Kenyan women are functionally illiterate (that is, not equipped with the skills necessary to function in the modern work environment), which means that they are effectively excluded from the advantages globalisation offers.

COMMERCIALISATION OF AGRICULTURE

Boserup (1978) observed that in Africa, extension of the market system has tended to marginalise rural women economically because males took control of cash and often assumed responsibility for cash-earning activities. Cash cropping has reduced opportunities for rural women to produce subsistence crops and provide food for their families, especially children. Even when men are involved in village-based export cash crop

cultivation, women provide most of the labour for these agricultural operations, which are in addition to their responsibilities in the food sector. Women's labour input is invoked as free labour, and men maintain control over most of the earnings from cash crop production. As men become more integrated into the monetised economy, women gradually lose control over means of production while expanding their work burden (Blumberg, 1991).

Julin (1993) says that modernisation efforts in the agricultural sector have been directed towards cash crop production. New technical innovations have primarily been made in activities that are traditionally 'men's work'. Men's productivity has therefore increased resulting in decreased demand for male labour, while demand for female labour has increased due to the larger land areas prepared by men and the increase in the number of crops. Where the structure of agriculture is becoming commercialised, women's roles and thus their economic status are changing. As revenue-generating cash cropping rises in importance, the proportion of resources controlled by women tends to diminish. This is largely due to the fact that household resources, such as land and inputs, are transferred away from women's crops in order to promote the production of cash crops.

Agricultural inputs and training are rarely provided to female farmers. With the introduction of structural adjustments, services that were initially provided free like artificial insemination, extension services and so on have now become commercialised. With the declining female incomes, very few can afford the services of extension officers. Where training is free, women will not be allowed to attend training sessions. Most of the males who visit training centres are old retired men who attend because of their high status in society. Information is usually passed on to men who do not pass it on to women. Ethical practices also make it difficult for women to access extension services since most extension officers are men. Even efforts to reduce poverty through land reform have been found to reduce female income and economic status because they distribute land titles only to male heads of households.

Cultural and social barriers to women's integration into agricultural programmes remain strong since women's income is perceived as a threat to men's authority. While men are taught new agricultural techniques to increase their productivity, women, if involved at all, are trained to perform low-productivity tasks that are considered compatible with their traditional roles, such as sewing, cooking, or basic hygiene. Women's components of development projects are frequently little more than welfare programmes that fail to improve economic well-being. This means that women cannot take advantage of the opportunities opened up by globalisation.

Male out-migration has had a number of adverse consequences for women in terms of time and labour and, less directly, on the welfare of their families and on the resource base. Women are constantly making adjustments within a changing set of limitations on their time and labour to provide for the family's subsistence and welfare. They are more bound to the homestead, sometimes waiting for remittances that never come or are too little or too late to purchase fertiliser or hire labour for the agricultural season. Thus women seem to have failed to derive any benefit from the commercialisation of agriculture.

THE CASE OF THE KIKUYU IN KENYA

Before the coming of the white men to Kenya the Kikuyu culture was such that men performed all the ceremonies that needed to be performed, be they cleansing ceremonies, offerings to their God, marriage, birth and so on. During these ceremonies women played a very insignificant role. Their relative subordinate position in society is therefore historical. The situation did not change after the penetration of Christianity, since Christianity helped to perpetuate the Kikuyu women's subordination, although some of the customs like female circumcision, though still practised by some people, were condemned for being primitive. The Kikuyu have wholly embraced Christianity but maintained some of the old traditions of the position of the woman, and Christianity has not helped to change this perception.

Polygamy, which was an accepted custom before the white man came, was condemned by Christianity but it is still being practised, though discretely. The monetary economy has made it difficult for a man to support many wives and land adjudication and registration have also led to a reduction in the amount of land per person especially in Central Province.

As Western education found its place in Central Province, most families preferred educating boys rather than girls because girls are expected to get married and move out of their homes. It therefore means that educating boys is considered an investment for the future. Though the Kikuyu are considered one of the most highly educated people in Kenya, there are still very few educated women relative to men. Table 9.1 shows that 26.97 per cent of the females interviewed had never gone to school compared to only 8 per cent of males. The majority of the females (56.2 per cent) had achieved primary schooling or eight years of education. Although the majority of males also have primary education, there are more males than women who have secondary and tertiary education. Western education therefore enriched the traditional education, the process through which societal values were transmitted from one generation to another.

Table 9.1 Educational attainment

	N	Per cent never gone to school	Per cent primary education	Per cent secondary education	Per cent tertiary education	Total
Female	89	26.97	56.2	15.73	1.1	100
Male	97	8	57	28	7	100
Total	186					

Source: Authors' calculations, 2001 field work.

Dowry payment still exists among the Kikuyu. To them, dowry payment is a gift-giving ceremony, for a groom to thank his in-laws for giving birth to and bringing up his wife. They even have a saying for it (*igitunywo mwana ni iikagirio mungu*), that is, if you want to retrieve your child from a baboon, you have to bribe it with something. Since dowry can be refunded if the marriage fails to subsist (due to barrenness on the part of the wife, the wife's infidelity, madness and so on) the Kikuyu do not consider its payment as a way of buying a woman. However, situations have arisen where a woman dies while her husband has not yet paid dowry (or has not yet finished paying it), and the husband is not allowed to bury her until he pays up, and if he does not, the woman is buried by her parents. This makes dowry payment a real business transaction and the good in question is the woman.

Divorce of a woman who has given birth to children is considered bad and is rarely contemplated by the Kikuyu. However, for those women who return to their parents (divorced), their parents or other male siblings never accept them. In fact, a woman's father usually takes her back to her husband. Desertion or divorce were not known or accepted (in fact the Kikuyu do not have a name for divorce). However, with the coming of the colonialists and the introduction of Western culture, desertion is now a very common thing, especially for those women whose husbands migrate to the cities or towns to work leading to a rise in female-headed households. Also due to the negative attitude people have of divorce and polygamy, men marry other wives but do not publicly declare them and therefore, the first wives are deserted and left to fend for themselves.

Among the Kikuyu, who are the largest ethnic group in Kenya, most farmers are peasants and the majority of the small holders have between 0 and 2 acres Table 9.2 shows land distribution in acres in Nyeri district in Kenya. Prior to the British penetration, land among the Kikuyu was perceived as a sacred, generative resource belonging to the ancestors. To the Kikuyu, the Earth symbolised woman. Although land was perceived as

Table 9.2 Land distribution in acres

	N	0–2	2.1–4.0	4.1–6.0	6.1–8.0	8.1–10	10 and >	Total
Female	89	71.91	14.61	5.62	3.37	1.12	3.37	100
Male	97	49.48	26.80	8.25	9.28	2.06	4.12	100
Total	186							

Source: Authors' calculations, 2001 field work.

belonging to the ancestors, use rights derived from patrilineages. Land was held by the clan or lineage, and was administered by a guardian of the lineage's land. He allotted portions to male heads of families according to need and availability (Muriuki, 1974). Men who had a number of wives required more land than those with only one or two wives. Male heads were obligated to provide each wife with sufficient land on which to raise food for herself, her family and visitors. Consequently, women had guaranteed rights to arable plots of land. Increased population and the post-independence land market boom mean that women have access to less land than before.

Women did not inherit land. They gained access to land as wives. Unmarried daughters also were given smaller, temporary plots to cultivate until they married. Therefore, pre-existing land tenure practices were based upon principles of obligation and responsibility that ensured that land held was cultivated within a certain time period and that all members of society, regardless of gender or social status, had access to land.

Enacted into law in 1954, the Swynnerton Plan was intended to encourage African farmers to consolidate holdings under individual rather than collective ownership. Land use patterns in the reserves were to be abandoned and all land with agricultural potential surveyed and consolidated into individual holdings.

The Swynnerton Plan undermined women's relative economic stability in rural areas in three ways: (1) it gave precedence to individual ownership invested in male heads of households and in turn marginalised the usufruct rights of women formerly guaranteed under lineage tenure; (2) since land as collateral was required and few women held land in their own names, the plan created disadvantages in women's abilities to secure credit for agricultural improvements; (3) the plan fostered the commercialisation of agriculture by encouraging export crop production by Africans for the first time – a development that further marginalised the labour of women in food production. Hence, the plan set a precedent for male domination of income producing agriculture. Without land, women were reduced to a state of

Table 9.3 Land ownership

	N	Percentage that owns land	Percentage that does not own land	Total
Female	89	38	62	100
Male	97	63.92	36.08	100
Total	186			

Source: Authors' calculations, 2001 field work.

Table 9.4 Farmers visited by extension officers

	N	Percentage visited	Percentage not visited	Total
Female	89	11.24	88.76	100
Male	97	26.80	72.16	100
Total	186			

Source: Authors' calculations, 2001 field work.

dependency with no security and only provision of labour (Nasimiyu, 1985). Table 9.3 shows the ownership of land in Nyeri district.

As Table 9.3 shows, only 38 per cent of the 89 women interviewed owned land, and on further questioning, none of them could produce a title deed for the land as they were just holding it in trust for their sons. Nearly all the land is registered in individual male's names and when they die, little effort is made to transfer title legally. Consequently, a widow continues to cultivate her husband's land without transfer of title to her name. For those women who had bought land, for example the single and the separated ones, they had registered their land in the name of their son or of another male relative.

In addition, technical inputs and agricultural extension services promoted by transnational and national donor agencies in the post-independence period to increase production among smallholders have continued to favour male rather than female producers (Staudt, 1982). The same study found that only 11.24 per cent of the women farmers compared with 26.80 per cent of the male farmers had been visited by extension officers, as shown in Table 9.4.

Moreover, only 16.85 per cent of the women farmers had attended any training on good farming techniques compared with 24.74 per cent of the male farmers (Table 9.5).

Table 9.5 Farmers attending training on good farming techniques

	N	Percentage attended	Percentage not attended	Total
Female	89	16.85	83.15	100
Male	97	24.74	75.26	100
Total	186			

Source: Authors' calculations, 2001 field work.

Table 9.6 Access to loans and farm materials

	N	Percentage of farmers who have borrowed loans and farm materials	Percentage of farmers who have not borrowed loans and farm materials	Total
Female	89	14.83	85.17	100
Male	97	44.33	55.67	100
Total	186			

Source: Authors' calculations, 2001 field work.

The Kikuyu are highly patriarchal, strongly believing in the domination of women, and women can never be considered equals of men. Women are more home-bound (to look after children and cook for the husband) while the men are supposed to provide for them. However, with the introduction of the monetary economy, migration and cash crop farming, women have taken over the tasks that men used to perform. After land adjudication and registration, men were registered as the owners of the land and women were left out. This means that with the introduction of Western culture and men moving to the cities to 'earn', women have been left to mind the homes as well as participate in agriculture. Without title deeds, women cannot attain loans. Extension officers also prefer giving services to male farmers. Table 9.6 shows that out of a sample of 89 women only 14.83 per cent had had access to loans and other farming materials while 85.17 per cent had not borrowed due to lack of collateral and huge transaction costs and they also said that banks discriminate against them because they are women.

The Kikuyu culture allows men to discipline their wives by beating them every now and then. In fact, most women would think their husbands did not love them if they did not hit them once in a while but not to the extent

of killing or disfiguring them. This has not changed even with the introduction of Western culture. Many women in Kenya have died at the hands of their spouses but such cases are treated as domestic matters and the culprit is usually set free as in most cases the male judges say that the man was deeply provoked by his errant wife. Since wife beating is not regarded as an offence, couples will probably be advised to sort out their problems quietly.

The Kikuyu used to perform female circumcision as a rite of passage from childhood to maturity and it was a taboo for a woman to start her menstrual period without having been circumcised. A cleansing ceremony had to be done. It was also another way of reducing a woman's sexual drive. With the coming of modern civilisation female circumcision is now termed female genital mutilation and although the Kikuyu have almost abandoned it, the poor and the rural people still practise it to some degree even though it is against the law. However, among other communities in Kenya practices such as female genital mutilation and other forms of physical disfigurement remain a serious threat to many women. Women cannot always depend on justice systems to protect them from violence.

The above description shows that the Kikuyu have retained most of their traditional, cultural and institutional traits despite the influence of public policy and the advent of Western culture and Christianity. Some of the institutional arrangements have been discarded but for those still practised, they have affected the way in which women and men earn their livelihoods and they have also acted as institutional barriers to women's empowerment.

CONCLUSION

This chapter has shown that sociocultural institutions have been acting as deterrents to women's empowerment. The subordinate position of women is mainly historical as portrayed by the case study. The socialisation process that women go through still portrays a woman as a wife and mother and that she should never compete with men as society does not allow it. Valuable resources are allocated in such a way as to deny women property rights, resulting in a lack of economic empowerment and all that goes with it. This has translated to women remaining at the bottom of the ladder in their socioeconomic status. Women have not benefited from macroeconomic reforms such as structural adjustment programmes, globalisation, agrarian reform and so on, and in fact these reforms have just enhanced women's lack of empowerment. For example, globalisation creates an environment that allows many women to achieve greater personal autonomy but in an increasingly unequal and risky environment. However, it intensifies some of the existing inequalities and insecurities to

which poor women are subject, but for educated, professional women, it opens up new opportunities. Women's capacity to manage new risks and to take advantage of new opportunities, including new information and communications technologies, must be enhanced.

Women-friendly financial institutions based on greater participation and accountability must be created. At the same time, the elimination of gender bias as a 'development distortion' must be a central objective of public policy if development gains from new opportunities are to be maximised. Business corporations must be encouraged to commit themselves to social responsibility and accountability in all operations. Markets, technology and economic policy must be transformed so that they operate fairly, and deliver the potential fruits of globalisation to poor women.

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10. WTO and the dangers of privatisation: an analysis of the Saudi case*

Jean-François Seznec

INTRODUCTION

Economic structures in the Persian Gulf have evolved as a response to societal needs, not market needs. Attempts to modify, or liberalise, these structures by merely changing the rules of the market, such as is being tried through the WTO negotiations, will fail unless the causes that created these economic patterns are understood and addressed.

The economic structure of the Kingdom of Saudi Arabia is somewhat different than those of any other place. This chapter will present in some detail a view of the structural form of the Saudi system as of late 1998, analyse how it has evolved the way it has and review the changes to this structure presently taking place.

The evolution of the Saudi economic structure over the past 25 years seem to have reflected the need of the leadership, especially that of King Fahad, to solve societal problems through economic structures. In order to maintain stability in the kingdom, while maintaining the absolute control of the state by and for the royal family, Saudi Arabia developed an economic model that fostered a total separation of the royal family from the commoners.

This separation which has been fully in place until late 1998 and which, by and large, is still the norm, provided for the complete control of industry, finance and oil by the commoners, while leaving all matters of internal security, military matters and land to the royal family. The realm of the royal family was not designed merely as a control mechanism of the means of repression. In fact it is just the opposite. The king's incentives to the royal family to control the military and security apparatus allow the princes to focus on the very large military expenses and subsequent commissions and prestige, thereby removing the financial need to be involved in business, finance and energy related activities. In turn, this allows the commoners to access the large sums of money spent on the rest of the economy,

including oil, and as such keeps the number of disgruntled citizens very low, minimising the need for heavy repression while maintaining control.

The separation of royals from commoners did not happen overnight; it evolved over the past 25 years. The ultimate cause of the policy of separation can be boiled down to the fact that the royal family is above the law, and that the king cannot impose obedience of the law on the royal family as he depends on the family for his legitimacy. The king, early on in his career, as adviser to two previous monarchs, may have realised that the royal family could take over the assets of the commoners at minimal compensation. Therefore, unless he found a good economic place for the family away from the commoners, there would be tensions in society. Since commoners outnumber the royal family one thousand to one, long-term tensions would break the royal family's hold on the state. Therefore a tight but generous separation of economic structures was needed to keep 'peace in the valley' and the ultimate control of the state by the Al-Saudis (Figure 10.1).

Efforts to change the economic structure of the kingdom are likely to fail if they focus solely on changing the apparent rules of trade, business and investment. In this context the negotiations to join the WTO and the efforts exerted on the Saudis to 'open up' their economy to foreign competition are not likely to have the expected effects. In fact no amount of economic liberalisation will be implemented properly until the basic societal problem of the status of the royal family relative to the law is resolved.

Similar analysis could probably be made about other Gulf countries. Certainly the accession of Bahrain, Qatar or Kuwait to the WTO will have enormous impact on the local societies and may bring some substantial disruption in the relationship between the rulers and the ruled and the social order in general. It is much more likely, however, that the local states have only limited intent to abide by the liberalised economy implied in the WTO regulations.

A comparison of the impact of the liberalised economies of the Gulf countries may show that all their economic structures also evolved along societal needs, not market needs. Any changes to the economic structure will be effective only if the societal needs allow it.

Trying to change the local rules of the game without considering their causal background will lead only to these rules being violated or simply ignored. This will also lead to potential conflicts with the more developed countries who will expect 'fair play' on signed agreements. For example, if foreign 'widget' manufacturers do not wish to go through local agents and pay them the standard 15 per cent commission, there may be a very strong push within a given state to stop imports of Western 'widgets'. This would bring suits at the WTO. The suits would be lost by the Gulf States, but the judgments would still be ignored, eventually leading to the withdrawal,

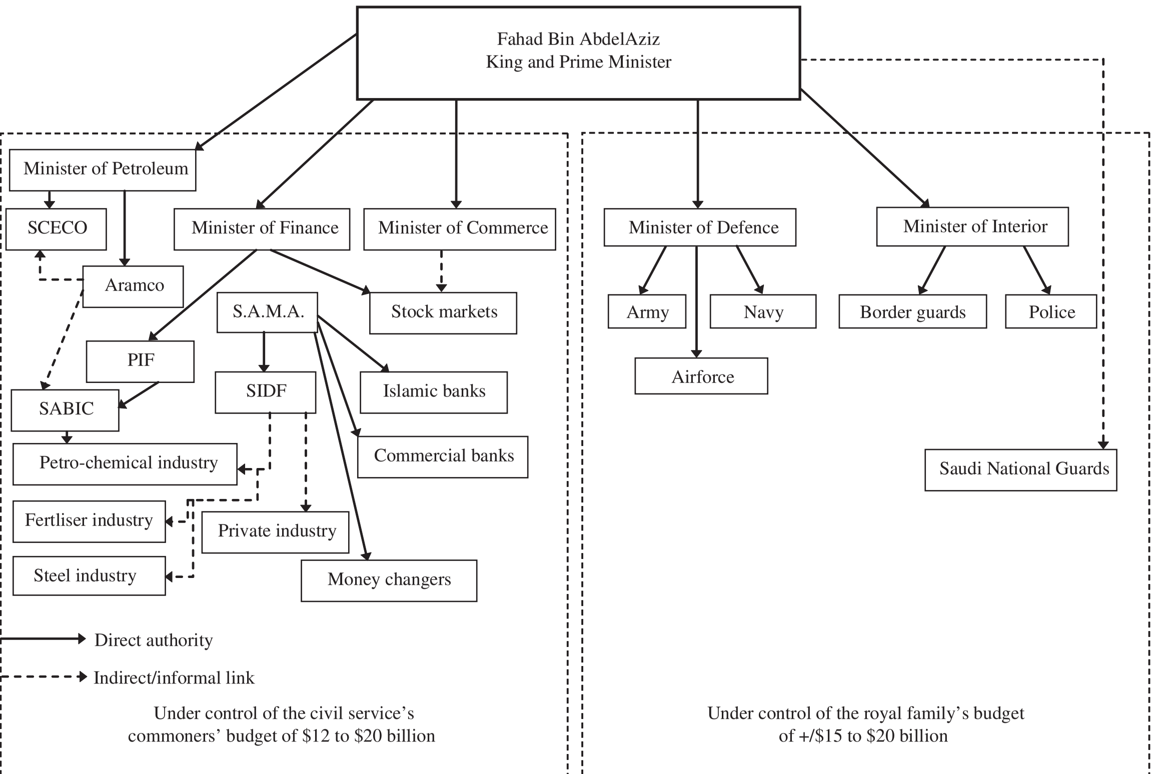

Figure 10.1 Control of the royal family in the Saudi Kingdom

de jure or *de facto*, of the state from the organisation. No foreign pressure will succeed in forcing society to adapt. It has to come from within.

SAUDI ARABIA'S ECONOMIC STRUCTURE BETWEEN 1973 AND 1998

Institutions which control large flows of money in the kingdom are managed either by the royal family or by the civil service composed of commoners, never by a mix of these two groups. For example, until January 2000, the oil sector was completely managed by the civil service. The Minister of Oil and Minerals is always a commoner; so is the president of the Saudi oil company, Aramco, and all the staff of both institutions. The Saudi approach to state owned economic management has been to place the oil sector in the hands of the most professional people. This professionalisation of the oil sector has spilled over to the main electricity companies where the top staff is usually ex-Aramco. Aramco still has a large number of foreign employees, but at the management level most positions are held by Saudi civil servants, all of them commoners.

The Ministry of Finance (MOF) is also controlled by commoners. The Minister of Finance has always been a commoner. Perhaps the most influential Saudi minister in modern times has been Mr Mohammed AbalKhail who stayed in the position from 1971 to 1995. Under his guidance and his strong influence over the Saudi Arabian Monetary Agency (SAMA, the central bank of Saudi Arabia) the MOF became very influential on the whole economy. SAMA, which regulates the banks, issues the currency and invests the country's reserves. It does not carry independent fiscal or monetary policy. In turn SAMA has a strong role at the board level and on the staff of the Saudi Industrial Development Bank (SIDF). SIDF funds most of the private industrial ventures. SIDF's funding includes loans of up to 15 years, interest free and with long and generous grace periods (up to five years). Without SIDF funding private industrialists would find it very difficult to get started as there are no medium term loans available from banks, no venture capital firms and a very limited stock market.

The MOF has a strong hand in the management of the Public Investment Fund (PIF). The PIF was created in 1971 to provide capital to major state-owned companies. The original plan was that the PIF would invest in various large concerns and once established and profitable, it could then resell its shares to the public at large. In fact, none of the PIF shares have ended up in public hands. The PIF today owns the airline company, the bus company and almost 70 per cent of the Saudi Arabian Basic Industries Corporation (SABIC).

In line with the other institutions controlled by the MOF, none of the firms owned by the PIF have any involvement of the royal family, except to a certain extent Saudia, the airline company. One cannot underline enough the fact that SABIC is as important to the kingdom as Aramco. Indeed, SABIC is seen as the future of the country. The overall sales of SABIC in 2000 were $7.1 billion and its net profits after tax $967 million. More importantly, it employed 25 000 people, 76 per cent of whom were Saudis. SABIC buys petroleum products and natural gas from Aramco and through 16 industrial ventures manufactures over 21 million tons of petrochemicals, metals, fertilisers and so on. In 2000, SABIC's capacity was 28 million tons, an increase of 10 million tons over 1999 and is scheduled to increase production to 48 million tons by 2010.[1]

The two pillars of Saudi wealth and future growth are Aramco and SABIC and both are entirely controlled by the commoners of the civil service and through the Ministry of Oil and Minerals (MOOM) and the Ministry of Finance (MOF). Both are managed by senior civil service commoners, whose sole allegiance is to the king directly.

The MOF also had complete control of the financial sector. The banking sector is 100 per cent privately owned. However, the influence of the Monetary Agency is pervasive. The three largest 100 per cent Saudi owned banks are under very tight scrutiny from SAMA. The largest, the National Commercial Bank, fought for a long time to keep its full independence, but weighed down by large bad loans and a very nasty brush with the US authorities on their involvement with BCCI, had to take the PIF as a 50 per cent shareholder, thereby giving the MOF and SAMA control of management and policy. The Riyadh Bank, for many years the second largest bank in the kingdom has been under SAMA's close supervision since it almost went bankrupt in the 1970s. The third purely Saudi Bank, and the third largest today, is AlRajhi Banking and Investment Corporation, the only Islamic bank officially licensed in the kingdom. AlRajhi only won its licence after four years of negotiations on how it could operate as a bank in Saudi Arabia under full supervision from the Monetary Agency. The other banks were originally foreign-owned and now only have minority foreign shareholdings. Their boards are Saudi-controlled and when they were Saudi-ised in the 1980s, SAMA had the responsibility of vetting the board members, the founding shareholders and the chairman of each bank. Thus the influence of SAMA has been very powerful within the banks. Further many of the Saudi officers in the banks have been at one point or another employees of SAMA, SIDF or the MOF.

The stock market also seems to be entirely under the control of the MOF. Officially the stock market is regulated by the Ministry of Commerce. In 1987, a stock exchange floor was actually opened for trading in Riyadh.

However, the floor was closed within 30 days by order of the Minister of Finance. Today all purchases and sales of shares can only be done through the banks, supervised by SAMA. Total market capitalisation is over $67 billion and 76 companies may be traded. The ability to float shares on the stock market is highly regulated by SAMA. Any company willing to issue floatable capital is vetted for a few years by SAMA. It must show a history of profits, reputable board members, and be within the guidelines of the five-year plan. Most of the companies traded on the stock exchange, one way or the other, are fully dependent on the goodwill of the Ministry of Finance or the Ministry of Oil for their core business.

For example, much of the daily stock trading is in bank shares. However, the banks' income comes principally from lending to state-owned or controlled firms and the large amount lent directly to the state in the form of development bonds and treasury notes. The banks also receive large fees from confirming letters of credit for Aramco, performance bonds for most of the ministries and the cash deposits related to these transactions.

Other companies whose shares are traded in the stock markets are Saptco, the transportation company, fully dependent on state subsidies and guaranteed dividends, SABIC which is 70 per cent owned by the PIF, cement companies which rely on cheap access to energy and so on. Therefore, it is safe to say that the stock market is under full control of the MOF. Naturally, this is a major impediment to the development of entrepreneurship in the kingdom, which in turn is a major brake to the economic development of the country by the private sector.

EVOLUTION OVER THE YEARS

This very tight control of these major sectors of the economy by the civil service, in particular by the MOOM and the MOF, did not happen suddenly. The banking sector for example saw its first major change when the foreign banks were told to 'Saudi-ise' or be shut down. In the late 1970s the demand for banking products was huge with over $100 billion being spent by the state to modernise the country. The foreign banks were operating in the kingdom through wholly owned branches and could easily have developed their infrastructure to meet the demand. However, they were major competitors to the two Saudi banks, NCB and Riyadh Bank. When told to create a capital base and allow a 60 per cent Saudi shareholding to continue operations, the foreign banks mainly cooperated. The profits to be earned from the increased business in the kingdom would outweigh the loss of control. Further SAMA had very large deposits in the home banks of the old branches and could influence priorities in the home

countries. Only Citibank, which had a strong policy of not undertaking joint ventures anywhere, was reluctant to accept the change, but, seeing the profit potential in the Saudi market and the very large deposits of SAMA at the bank, relented and created the Saudi American Bank. The Saudisation of the banks was largely controlled by SAMA, which, as mentioned earlier, managed to have a strong say on how the board was chosen and the banks managed.

The National Commercial Bank, the largest bank (28 per cent of all banking assets) was privately owned, mainly by the bin Mahfouz family, and was not eager to place itself under the review power of SAMA. NCB was able to fend off the efforts of the MOF to dilute the bin Mahfouz by making it issue shares to the public, to demand properly audited statements and open its doors to SAMA inspectors. It managed to stay quite independent by providing large loans to the royal family. However, this proved to become the bin Mahfouz's undoing. During the notorious BCCI scandal, Mr Khaled bin Mahfouz was seen to be a major shareholder and favoured creditor of BCCI. Thus, when BCCI went bankrupt and its management placed under criminal investigation, the Attorney General of the State of New York shut down the National Commercial Bank branch in New York, and indicted NCB's major owner, Mr Khaled bin Mahfouz. This was a difficult blow for the bank, since it could not operate its foreign exchange desk, its letters of credit and performance bond operations or effect dollar transfers properly without US dollar accounts in New York. Only by obtaining the support of SAMA, who stated that it would support NCB's activities overseas, could the bank obtain the normal correspondent banking support of the US banks and of the Federal Reserve in New York. NCB lost its branch in Manhattan and Mr bin Mahfouz paid a $150 million fine, but the bank survived.

Not by coincidence, however, NCB 'asked' for a full audit by SAMA. This audit took one and a half years to be completed. The shareholders were required to write off $1 billion of bad loans and recapitalise the bank accordingly. This amount of money was sizeable even for the bin Mahfouz family who eventually had to settle for the sale of a 50 per cent interest, plus control of management, to the PIF, placing NCB squarely under the umbrella of the MOF.

The money changers, a traditionally very independent group of financiers in the Gulf, had always managed to stave off SAMA and the MOF. In Saudi Arabia, especially, they were very cash rich. They handled most of the remittances from the millions of foreign workers to the home countries. This gave the changers a very large float in the hundreds of millions of dollars. Investing this float became the main activity of the money changers. They used it to speculate in commodities. The money changers

who had traditionally been the buyers and sellers of gold, became buyers and sellers of wheat, sugar and so on. They set up very modern links to the main trading floors of Chicago, New York and London as early as 1978, buying and selling futures and options as well as the commodities, buying of the margin and so on. They also ran regular banking counters, providing cheques, loans and venture capital to local entrepreneurs.

Such activities were unsupervised and eventually one of the most aggressive money changers started taking very large positions in gold. Unfortunately the price of gold, which had risen to $850 an ounce over 10 years, collapsed to below $300. This money changer based in Damman (Abdallah AlRajhi, the oldest son of Saleh AlRajhi – the largest money changer in the kingdom, but entirely separate from his father) could not meet his obligations to his bankers, brokers, or most of all to the foreign workers whose remittances he failed to transfer. SAMA agreed to intervene, but only after the council of ministers agreed to force all money changers to report regularly to SAMA, and either cease all banking activities or seek regular banking licences from SAMA. Only Saleh AlRajhi in Riyadh agreed to seek a banking licence. SAMA made him wait four years for the licence. AlRajhi now operates as the only Islamic bank in the kingdom but under supervision from SAMA.

Other major sectors of the economy followed a similar pattern. Until 1975, the electricity companies had been owned separately in each city and developed helter-skelter throughout the kingdom. They were faced with a huge increase in demand in the mid-1970s and calls for common electrical standards throughout the country (Jeddah had European standard, Damman American ones, Riyadh a mix of both, and so on). The state established three major interconnected electricity companies. These companies bought out the local owners and established large new plants financed by SIDF. The management came mainly from Aramco. In this instance, the important electricity sector came fully under the control of the civil service.

The oil sector also came to be totally controlled by the civil service. In the late 1970s some princes tried to muscle in on the trading of oil (the most famous, but probably not the only one, was Mohamed bin Fahad's attempt to obtain commissions from British Petroleum which became front page news in the *Financial Times* in London). Very quickly the trading was limited solely to Aramco and Petromin, both civil service controlled. Eventually, Petromin was absorbed by Aramco. Today all petroleum sales and production are handled solely by Aramco.

The major economic development of Saudi Arabia in the 1980s and 1990s came from a hugely successful entry into petrochemicals. This was achieved by the establishment of the Saudi Arabian Basic Industries

Corporation (SABIC). SABIC was established as a holding company taking a controlling or complete interest in all the petrochemical joint ventures in the kingdom. Each of the 16 subsidiaries borrows separately. Seven of these subsidiaries have 50 per cent foreign ownership, but all are controlled out of the Riyadh headquarters. Again SABIC is fully controlled by the civil service, with no royal family members involved in management either at the holding or the subsidiary level. It is important to note that SABIC's sales will be above $10 billion in 2001, may reach $20 billion within three years, and that the company is quite profitable. The present rate of investments in petrochemicals by the private and public sector leads one to speculate that by 2020 Saudi Arabia will sell more petrochemicals than oil. Therefore the importance of SABIC in the kingdom is enormous. It is not yet as important as Aramco to the final income of the state, but since it adds value and creates jobs in its subsidiaries and all the numerous attached services, SABIC and petrochemicals in general are more important to the kingdom than Aramco and the production of crude oil.

DEFENCE AND MILITARY AND INTERNAL SECURITY

The military forces of Saudi Arabia are among the best equipped in the world. The kingdom has spent over $372 billion in the past 16 years[2] to obtain the best airplanes, tanks, missiles, ships and detection systems that money can buy. A good portion of this money was spent employing a large number of foreign technicians to train the Saudi forces. Nevertheless, as a fighting force the Saudi military services were not able to deter the large forces of Iraq, or for that matter were not able to have any major role in the fighting against Iraq in the Desert Storm campaign of 1991.

The weakness of the Saudi forces is due in part to its dual structure. The Ministry of Defence ('MOD') controls the army, the air force and the navy all totalling 105 000 men. The Saudi National Guards ('SNGs'), which total 57 000, are under a totally separate command. They have their own budget and plans. The military structure and the subsequent huge cash flows spent to support them are a way for the king to preserve the unity of the royal family. By allowing enormous expenditure on both the Army side and the National Guard side, the king is able to insure that a coup will not take place, as both sides would exhaust each other; to give to the main contenders to the throne an appearance of power and plenty of money to maintain themselves and their retinue; and to give the impression to his people that the oil money is spent for the glory and honour of Saudi aims and goals. Theoretically the armed forces are responsible to the king. In practice,

however, the National Guards know only one ultimate commander and that is Prince Abdullah bin AbdelAziz, the crown prince. The army, air force and navy are under the command of the Minister of Defence, Prince Sultan bin AbdelAziz. Prince Naif bin AbdelAziz, the Minister of the Interior, for his part controls over 120 000 employees[3] including the secret police, the coast guards and the border patrol. The other major intelligence group is the General Intelligence which was run until August 2001 by Prince Turki Al-Faysal and reported directly to the king.[4]

The amount of control that the king actually exercises over the various services (army, navy, SNGs, and so on) is somewhat limited by the fact that the king cannot easily dismiss the junior princes or order around the more senior ones. There is no Joint Chief of Staff who could centralise and coordinate operations between the various military branches.

The independence of each of the services is checked by a sprinkling of family members throughout. At the SNG, Prince Abdullah's deputy is Prince Badr bin AbdelAziz, a half-brother to the king and to Prince Abdullah, and two of Abdullah's sons are commanders. The MOD has at least 12 major princes from various clans and a large but unknown number of lesser princes.

Some of the most expensive weapons systems bought by the kingdom cannot be used effectively against its major foes. For instance the various F-15s and the AWACS purchased from the USA lack the sophisticated equipment that makes the plane useful against Israel. They lack IFF recognition capability.[5] They lack advanced ELINT (Electronic Interdiction) systems, and this precludes them from seeing US-type (that is Israeli) aircraft and detailed ground activities. These omissions were made in order to get the sale to pass through the US Congress, but ensures that the Saudi forces are dependent on US support to fight foreign aggression.

The senior princes like Prince Bandar bin Sultan, Prince Sultan and the king himself certainly know the weaknesses of the systems. The Saudis would have preferred to obtain the weapons with the right equipment. However, Iraq's invasion of Kuwait and its subsequent defeat by external forces have underlined the Saudis' inability to defend themselves from external threats. One can ask why the Saudis have spent $372 billion on a military force organised to be inefficient and equipped with systems that do not defend the country against at least one of its major foes.

All suppliers to the military are Saudi merchants or foreign firms working through Saudi intermediaries. Unlike civilian government contracts, which must be competed for in closed bids, Saudi military contracts are negotiated. Most of the Saudi firms and intermediaries involved in the negotiated contracts are directly or indirectly controlled by members of the royal family.[6]

Therefore, the Saudi military structure may appear very weak and poorly organised, but not so by accident. The military organisation is merely a solution to an internal political problem. The king must maintain the cohesiveness of the Al-Sauds in spite of the competition for power within the family. His only tools are persuasion and money. It is important for him to allow the senior princes to feel important and powerful but to limit their power in a subtle but efficient manner.

SUMMARY OF THE SOCIOECONOMIC STRUCTURE

Figure 10.1 illustrates the very surprising dichotomy in the kingdom's socioeconomic structure. The commercial, industrial and financial sectors are tightly controlled by the commoners of the civil service. In a country where the royal family has absolute political control, this cannot be by accident. Naturally, the family has received its share of the oil spoils through the military and security expenditures, but it is unlikely that without the close hold of the civil service on the rest of the socioeconomic structures, the princes would have been satisfied with their proto-apartheid situation.

Ultimately the civil service is responsible to the king. Without the king's support, the present structure could not have evolved. In fact, one can infer that this socio economic structure was designed by the king. The purpose of the structure is ultimately to make sure the tensions between royals and commoners do not become unbearable to both parties. Since both commoners and royals can manage a very large sum of money and maintain professional control of their own bailiwick, peace is kept in the valley.

Unfortunately this is done at a substantial financial cost. On the one hand, the military is kept inefficient but rich. On the other hand, the very tight control of the economy by the civil service to maintain the structure creates bureaucracy and limits entrepreneurship. Since only entrepreneurs can create enough jobs for the fast-growing population, the state is caught in a dilemma. If the financial markets are relaxed, firms allowed to raise capital easily, privatisation of state assets undertaken and thus the economy kicked forward, then the royal family can easily use its large overseas deposits and its above-the-law status to take major controlling shares in the energy, petrochemical and financial sectors. Such a takeover would crowd out the commoners, and ultimately bring unprofessional management to the jewels of the Saudi economy, such as Aramco and SABIC. This would create tensions, loss of market share and ultimately prominent questioning of the royal family's birthright to leadership.

EVOLUTION SINCE LATE 1998

Finance

Until 1998, the financial sector was controlled solely by commoners. The owners of banks and the boards of directors consisted only of commoners and the supervision by SAMA and the MOF was also entirely carried out by the civil service, itself controlled solely by commoners. The first major change to this pattern came when a small bank opened its capital to Al Waleed bin Talal bin AbdelAziz. The Saudi United Commercial Bank (since then renamed United Saudi Bank, USC), was founded in the 1980s. It remained quite a mediocre player in the banking market until 1998 when Prince Al Waleed bin Talal became a 30 per cent owner and chairman. In 1998 the bank was allowed to take over the bankrupt Saudi Cairo Bank. In the mid-1990s, Prince Al Waleed built a 5 per cent stake in Citicorp (the holding company of Citibank, New York), becoming its largest shareholder. This furnished his reputation as a savvy investor and banker. It also gave him a strong link to the Saudi American Bank (SAMBA), partly owned and managed by Citibank. In 1999 Al Waleed bin Talal was able to leverage his knowledge of banks and became the largest shareholder in SAMBA. Since then, SAMBA started growing more aggressively and became the second largest bank in the kingdom, with 23 per cent of all the banking assets. SAMBA is technologically the most advanced of the all the banks in Saudi Arabia, the most profitable, and is very likely to become the leading bank in the kingdom, and the only one with a royal connection.

Oil

Another major change in the economic structure of the kingdom has been the establishment of the Supreme Petroleum Council in January 2000. This council is now in charge of establishing policy for oil production. The council is chaired by the king and co-chaired by the crown prince and Prince Sultan bin AbdelAziz (the Minister of Defence). The council has nine other members: eight are commoners, including the ministers of oil and finance, and one a senior prince, Saud Al Faysal bin AbdelAziz, the minister of foreign affairs, who is delegated to run the council's affairs.[7]

The council provides a major change in the policy procedures of the kingdom. Until its inception all major decisions on production levels, investments and OPEC policy were made by the minister of oil and the king, bypassing input from the major princes. The implementation of these decisions was undertaken by the MOOM and Aramco, both entirely staffed by commoners.

The new council was established shortly after efforts had been made by certain members of the royal family to allow foreign investments in the production segment of the oil sector (most often called the 'upstream sector'). The kingdom, which already has a 10.5 million b/d of capacity, is the only producer in OPEC who can rapidly fulfil any potential shortfall in supply. Many forecasts predict that the increase in demand in the West and especially in the Far East will create a 10 to 15 million b/d shortfall. Saudi Arabia should be poised to take this big increase in market share and the resulting income from it.

The major oil companies, arguably, are needed in the Gulf to help develop the capacity for the estimated shortfall because such an increase would require about $50 billion in investments which the kingdom does not have at this time.[8] To test the interest of the foreign companies, Crown Prince Abdallah attended a meeting in Washington with the main US oil firms in September 1998 organised by the ambassador to the USA, Prince Bandar bin Sultan bin AbdelAziz. Prince Abdallah asked the companies for 'suggestions' on how they could return to the upstream sector in the kingdom.[9]

However, shortly after the meeting the minister of oil announced publicly that upstream investments by foreign oil companies were not needed because Saudi Arabia already had unused capacity of about 1.5 million b/d and that the increased needs of the world were far from being proven, especially since at the time the Far East economies were barely recovering from the 1997/1998 downturn. Behind this meeting and statements lay the fact that Aramco is able to develop the oil production itself. It has done so in the past with great success.[10] The geology of Saudi Arabia does not require the extensive technological miracles of the North Sea and even if it did, it could easily purchase the support of large US, French or Norwegian engineering firms. The capital needed, of course, is very large, but if handled gingerly such amounts over time could be easily provided to Aramco by the world financial markets.

The actual request for 'suggestions' from the oil majors on reentering the upstream sector was not generated by Aramco or the MOOM, but seemingly from the royal family. In 1998 the price of oil was below $15/b due to the crisis in the Far East. The societal split discussed above requires large sums to be disbursed to the royal family side of the equation. With oil income falling $30 billion per year, the amount allocated to defence and thus available to the royal family was shrinking. It seems that many senior members of the family felt that oil should come back under their control. Inviting the foreign oil companies back in meant that:

1. The royal family could take control of oil policy from the civil service.
2. The royal family could decide what volume should be produced and take back control of the sale structure, that is, reintroduce a role for the royal family in the flow of money from the Aramco sales to the ministry of finance.
3. It left open the possibility that major princes could be the sponsors of the foreign oil firms, thereby replacing commissions on arms purchases by commissions on oil production.

The announcement of the minister of oil dampened all these possibilities, but a compromise was found. The gas upstream sector was opened to foreign companies and the oil policymaking was transferred to the new council.

The compromise, however, was a victory for the civil service. The gas upstream sector is relatively small compared to the oil sector. Gas production in the kingdom is not very profitable compared to oil. The gas has to be sold locally, putting the investors solely in the hands of the Saudi civil service which controls the users, i.e. SABIC for petrochemicals and SCECO for electricity production. The large contract signed by Exxon Mobil in June is interesting to Exxon, not so much because of the potential profits, but because it may lead to access to the kingdom's oil reserves which had been closed since the mid-1970s.

The other leg of the compromise, the creation of the Supreme Petroleum Council, does transfer policymaking to major princes. However, it is significant that the man in charge of running the council, Saud Al Faysal, is reputed to be of high integrity, not close to the Americans, and not close to the senior princes of the Sudairi line, such as Prince Sultan or Prince Naif. This means that the council cannot be counted on to become a rubber stamp for US requests to increase production, nor a body pushing production for the sake of immediate income for financing military and security expenses.

Hence, even though there are changes to the 'social contract', the basic structure is still in place. The major sectors of the economy are still controlled by the civil service and the military and security by the royal family, with the sclerosis of the economy that it has created.

LIBERALISATION, PRIVATISATION AND WTO NEGOTIATIONS

The Saudi Advantage

The kingdom is faced with the major challenge and opportunity of huge population growth. A 3.5 per cent to 4 per cent annual growth rate requires

that at least 250 000 jobs be created each year.[11] The jobs will be created by taking back the jobs of the 6-odd million foreigners and/or from new industries and services.

Many of the foreigners' jobs could be handled by Saudis, but many tend be low paid and low skilled. Saudi employers prefer to hire foreign labour which under the present laws is kept in semi-slavery with no rights and low wages. There are no incentives today to hire Saudis to perform menial duties. The more highly paid and prestigious jobs presently held by foreigners, such as accounting, engineering and middle management, are better targets, but still subject to the same lack of incentives to replace foreigners with medium to good pay but no rights or job security by Saudis who will require good pay and rights and security. The main state-owned Saudi firms, such as SABIC, are mostly Saudi staffed, but not the private firms.

One of the solutions to the employment issue is to develop industry rapidly which will create jobs to be filled by Saudis. To do so, the kingdom needs to develop industry where it has a natural advantage, i.e. in energy related, value-adding products. In essence, it means the future of the kingdom is in petrochemicals and energy-based production such as aluminium or direct reduction steel.

SABIC now controls about 5 per cent of the world's chemicals and will probably have a market share of 9 per cent within 3 to 5 years.[12] This increase will create jobs, but not enough. The country needs to rely on industrial job creation by the private sector. The private sector already produces 1.1 million tons of petrochemicals and has projects to produce a further 3.5 million within two to five years.[13] A major increase by the private sector in this field could increase Saudi market share in petrochemicals to 12 to 15 per cent in the near future. Such a market share will create important conflicts with the existing producers, mainly the German, American, French, British and Japanese firms who now have the lion's share of the world market.

The kingdom has the cheapest energy production costs in the world. The Saudi cost of oil production is between $0.75 and $1.50 per barrel. By contrast, the equivalent cost to BASF of Germany, the world's largest petrochemical company is $25.0 per barrel. Since the main cost of petrochemicals is the raw material of oil or gas, this difference could allow the Saudis to undercut the price of any petrochemical and conquer any market. The Europeans have already argued that SABIC's products need to be taxed to make up for the 'unfair' advantage of Saudi costs. Today, SABIC buys its feedstock from Aramco at a discount of about 30 per cent on world prices for equivalent products. If this is considered 'unfair', it will be interesting to estimate what would happen if SABIC bought its feedstock from Aramco at the local production cost plus a normal profit margin for the oil company.

Another way of looking at the issue would be to see what costs SABIC would incur if it took over Aramco and sold to it the production it does not need as feedstock for exports. It could be argued that SABIC's feedstock costs would then be reduced not by 30 per cent but by a factor of 25.

Joining WTO would allow the Saudis to argue successfully their cost advantage and keep the markets open for their petrochemical production. Allowing WTO judgments in favour of the Saudis will undoubtedly level the US and European petrochemical industries within twenty years. However, this is the true price of globalisation, and hopefully will decrease the prices of petrochemicals enough to encourage the Western and Japanese firms to develop more and better uses for these petrochemicals in light chemistry, (medicines and so on) where they have a natural advantage.

If Saudi Arabia accedes to WTO, this competition for market share will dominate the debate in Gulf–Western relations and will ultimately benefit the kingdom as well as all the other producers in the Gulf such as Kuwait, the UAE and Iran. On the other hand it will not be purely a one-way advantage for the Gulf.

SAUDI PROBLEMS

Part 1

WTO requires that trade rules be liberalised and commercial laws and their implementation be transparent. It also discourages subsidies to local industries by the state.

Today most of the consumer and industrial products sold in the kingdom are imported. All goods and services must go through a local agent or representative who gets a commission. These agents are heavily protected and cannot be bypassed (no transfers of agency, no direct sales, and so on). The private sector, by and large, is very dependent on these agencies. Opening trade to foreign companies would mean a substantial switch away from the agent system, cutting out a very large safe source of income from the merchant families.

Opening the trade sector to the world will not necessarily cut out all the traders. Many products require substantial after-sales services, especially technologically advanced ones such as turbines or computer systems. Foreign companies will still depend on a strong local presence to provide the services needed. However, the foreign companies will be in the driving seat and control their own sales policy and the subsequent profits.

Foreign firms will still need local support and in the case of most smaller exporters will still rely on local distribution. However, income generating

will be a great deal more difficult for the average medium and small family firm in the kingdom. This may indeed create some pressure against the short term effect of WTO on society.

Part 2

Another very major impact will be the effects of privatisation and of liberalisation of the hold of the civil service on the economy. The first part of this chapter showed that society has to maintain a division between the royals and the commoners and that this division is enforced by the civil service's control of the economy. If because of WTO rules, the economy must be liberalised, this divide will disappear.

If the major profit-making state assets, such as SABIC, are privatised it is most likely that the capital of SABIC will be snapped up in the market by those Saudis with the biggest accounts abroad. These are basically the major princes and a few very large merchants. Since the large merchants are already involved in industry, it is likely that they will use their resources to continue developing industrial projects on their own, which would leave SABIC's shares prey to the royal family.

At 30 times earnings, the 70 per cent of SABIC which is presently state-owned would fetch $15 to $30 billion, with control obtained with $8 to $16 billion. Such a figure could be raised by a few major princes. If this were the case, the 'social contract' would be broken. There would be two major consequences: firstly, the commoners would be removed from important decisions which affect the most important long-term income- producing sector in the country; and secondly, the quality of management would drastically decline as royal family members would be able to promote incompetent sycophants and push for investments that would provide large fee-earning but non-viable projects.

Another problem of unfettered liberalisation in the kingdom would be the opening of the financial markets. As they stand today the markets do not create any engine of growth. However, if liberalised and removed from the tight control of the MOF, the royal family could start muscling in on private firms. This would create great tension between the royal family, the merchants and the small investors.

The potential for tension is based on the assumption that the royal family will remain above the law, and having bypassed the civil service can run roughshod over the commoners. Of course, WTO also requires that the local law be fair to all (including foreigners) and transparent. Hopefully a WTO accession would place the royal family under the law. Unfortunately, one cannot be sure that this portion of the WTO can be enforced as far as the relations between Saudis are concerned. As long as the royal family has

absolute control of the means of repression, communication and of the judicial appointments, it is unlikely that the average citizen will consider that he can fight 'city hall'. The only champions of the commoner will remain the king and the civil service. Of course, the king's interest is to keep the population reasonably satisfied to minimise tension and ensure the long term control of the Al-Saud family. However, he is placed in power by his own family. Thus, it takes a very strong, able, and masterful diplomat to juggle the support of the royal family while supporting fairness to the commoners.

King Faysal was able to provide such a balance at the time when the kingdom started its transition from a poor and undeveloped kingdom of the desert to the modern state it is today. He had the overwhelming respect of his people and of his family. The present crown prince, who since 1998 has been handling the affairs of the state for the ailing King Fahad, seems also to have strong support within the country. However, at 74 years of age, he needs to prepare his own succession.

Naturally, one should hope that the leadership will continue to see that the main problem of the kingdom in meeting the challenge of its own growth is to level the playing field between commoners and the royal family. Negotiating with the world to accede to the WTO will not achieve the results it could if this fundamental issue is not addressed internally. Otherwise, privatising and liberalising the economy will only create huge tensions. Most likely, WTO rules if officially accepted would be skirted or disregarded altogether. Indeed, given the choice of public strife or having a drawn-out legal battle at the WTO court, the Saudis, and most of the other Gulf countries, will choose the avoidance of strife.

NOTES

* This chapter was written in August 2001 and does not reflect the changes in Saudi Arabia since then.

1. All figures on SABIC were found in the 2000 audited Annual Report of SABIC at www.sabic.com.
2. See Cordesman (2000).
3. See Cordesman (1984). At the time this figure was larger than the Army and National Guards put together.
4. Prince Turki Al Faysal was replaced by Prince Nawwaf bin AbdelAziz, a first generation prince. Prince Nawwaf is widely seen as close to Prince Abdallah, the crown prince. This change can be interpreted as the crown prince securing his control over the intelligence services while the king is very ill.
5. IFF allows recognition of a plane as friend or foe (Cordesman, 1984, 590–600).
6. Personal notes from conversations in Riyadh between 1978 and 1983.
7. For the exact text of the decree of formation of the Supreme Petroleum Council see *Middle East Economic Survey* (2000).

8. This amount is computed by roughly estimating that developing production by one million barrels per day in the Gulf will cost between $4 billion and $8 billion. These estimates come from the EIA on production costs and from Professor Thomas Stauffer's paper *Crude Oil Production Costs: The Gulf versus Non-Opec Sources*, published in 1993 by the International Research Center for Energy and Economic Development in Boulder, CO, USA.
9. At present all upstream investments and production are handled solely by Aramco. Aramco will often subcontract engineering and drilling activities to foreign, often American firms like Halliburton, Fluor, or the French Schlumberger.
10. Aramco developed the newest Saudi field of high grade oil in the Rub Al Khali, a difficult place to drill, and brought 500 000 b/d to the market in less than two years.
11. Assuming a total Saudi-born population of 14 million a 3.5 per cent growth implies 490 000 new citizens per year, which requires at least half as many jobs.
12. The market figures are computed by comparing SABIC's production with the production of the 97 most common petrochemicals companies in the world as computed by SRI Consulting.
13. The figures on petrochemical projects are computed at the Lafayette Group of Annapolis, MD, by the author.

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11. Institutional impediments to women's empowerment in rural India

Kartik C. Roy

INTRODUCTION

Institutions set the conditions under which the process of empowerment works. The lives of poor women in rural India are governed by a number of such institutional factors, the most prominent among them being social customs and taboos. These exercise strong influence on other institutional factors affecting women's empowerment such as education and property rights. In this chapter, we discuss how the 'ideology of seclusion' embodying social customs and traditions imposes gender-based discrimination on women in their daily lives within and outside the surroundings of their homes, in pursuit of education and in exercising their property rights. The forces of the 'ideology of seclusion' need to be weakened to facilitate the empowerment process. Globalisation, by lessening the forces of the 'ideology of seclusion', can facilitate the empowerment process of women.

Economic empowerment is crucial to the success of any empowerment programme. But even when a woman is economically empowered, her social status may not improve because of lack of conducive social institutions. On the other hand, a woman may not be economically empowered if there is a lack of conducive economic institutions. Institutions therefore, are rules both formal and informal that bring predictability and stability in modern economic exchange. The absence of contract empowerment and property rights comes down harder on the poor, since they often lack secure property and have limited, if any, political connections. Among them, poor women suffer most as they receive limited support from institutional factors.

The lives of poor women in rural India appear in one way or another to be affected by a number of these institutional factors. The most prominent among these institutional factors is social taboos which make poor women lose their self confidence, control over their own income and even control over their own lives. These social taboos thus act as the most powerful

impediment to these poor women's empowerment.[1] These also exercise significant influence on all other issues including education and property rights. Despite considerable class, cultural and regional differences, rural households in Bangladesh, Pakistan and in northern India tend to exemplify a 'classic patriarchy' which implies the control of younger men by the old and the shelter of women in a highly hierarchical domestic realm. It also implies control by men of some forms of viable joint patrimony in land, animals or commercial capital (Kandiyoti, 1985), as under Islamic law, women cannot inherit land. Even where their land ownership rights are recognised, social customs may prevent women from exercising these rights. Hence their ability to exercise property rights, which is an important contributor to women's empowerment, is greatly influenced by social customs and traditions.

Similarly women's access to appropriate education which facilitates their empowerment is also greatly influenced by the same social customs of gender discrimination, which can be broadly termed as 'ideology of seclusion' or 'classic patriarchy'. A.K. Sen (1997) commented that the most glaring example of the failure of successive governments in India had been in the field of primary education, basic health services and land reform. All these had a direct bearing on the economic growth of the country. The empowerment of women was equally a relevant factor in the country's economic growth as it had a direct bearing on education and child nourishment. It was depressing that India would be entering the twenty-first century with almost 50 per cent of its population illiterate. Again he commented (in 2000) that a good education can make a dramatic difference to somebody's abilities and achievements. But the decision as to whether women would have access to any kind of education and if so, to what kind of education, would be greatly determined by the institutional factor: 'ideology of seclusion'.

In this chapter, we examine the relevant issues affecting women's access to education and property rights.

EXCHANGE ENTITLEMENT, ENDOWMENT AND EMPOWERMENT

Here we briefly outline Sen's theory of exchange entitlement, as it is highly relevant in explaining the powerful role that institutions play in women's empowerment in rural India. The entitlement relation as proposed by Sen (1981) is one kind of ownership relation which could be obtained by the following four methods: (i) trade-based entitlement, (ii) production-based entitlement, (iii) own-labour entitlement and (iv) inheritance or transfer

entitlement. One can exchange what one owns for other things. This exchange can take place either through trading, production or a combination of the two. The set of all the alternative bundles of commodity that a person can acquire in exchange for what he or she owns may be called the 'exchange entitlement' of what he or she owns.

The concept of entitlement is an advanced application of modern set theory with 'exchange entitlement mapping' that mathematically specifies the set of exchange for each ownership bundle. The entitlement set of a person depends on two parameters: (i) the endowment set of a person (the ownership bundle) and (ii) the exchange entitlement. The set of all such available community bundles in a given economic situation is the exchange entitlement of this endowment.

Apart from the endowment or ownership factor, the key determinant of a person's welfare is his or her exchange entitlement. For example, labour is the natural endowment factor for most people, a part of the endowment set for them. However, the key factor for his/her welfare is whether he or she can find employment (that is whether he or she can exchange his/her endowment or exchange entitlement) and, if so, for how long and at what wage rate.

The exchange entitlement differs from person to person on the basis of his or her economic class structure as well as on the modes of production of the particular economy. Even with a similar endowment bundle, the exchange entitlement will vary depending on his or her economic prospects. For example, two people with the same educational qualifications in rural and urban areas will have different exchange entitlement. One of the main causes of rural–urban migration is based on the entitlement differential. One of the main factors in the exchange entitlement differential is the gender factor. The gender factor, generically speaking, brings out into the open a number of issues that have not been fully discussed in Sen's theory of entitlement exchange.

According to the theory, a person's endowment can lead to entitlements which, when exchanged, can lead to the removal of poverty, empowerment and improvement in his/her socioeconomic status on the assumption that there are no institutional deterrents to exchanging entitlements. Since these deterrents exist, endowment may not automatically lead to this exchange of entitlement. Thus education, which is one of the main endowment factors, is supposed to help a person gain employment. However, education itself in the endowment set of a female does not necessarily improve her chances for exchange entitlement because of various institutional factors, which are related to traditions and customs.

Similarly, a woman may earn ownership rights to a property through inheritance, but the key factor for her welfare is whether she can effectively

utilise these property rights to obtain goods to improve her economic condition. Whether and to what extent she will be able to do that could depend very much upon social customs and traditions. The 'ideology of seclusion' prevents educated women in the rural sector from obtaining gainful employment and also prevents them from utilising their property rights to improve their economic condition.

Women tend to suffer from institutional impediments more than men do and among women, rural women suffer more than urban women.[2] Sen was aware of gender differences. In his later work (Anand and Sen, 1995) he has mathematically demonstrated that the exchange entitlement factor causes differences between males and females. However, he does not seem to have taken into account the institutional impediments, particularly the 'ideology of seclusion' that is the key deterrent to the removal of poverty and achieving empowerment for women in rural India.

GENDER-BASED INEQUALITIES IN ECONOMIC SOCIAL AND FAMILY DOMAINS

Social and institutional arrangements with their traditional anti-female bias have disadvantaged poor women in rural India. The degree of anti-female bias in poor families tends to be inversely related to a woman's effective contribution to the total family income and also to the amount of dowry that the parents and other male members would be required to pay at the time of her marriage. The woman's contribution to the family's sustenance can be considered effective if her work is socially visible and socially recognised as valuable.

As Agarwal (1989) notes, agricultural work which brings in earnings that are economically more visible than home-based work, and work which brings in earnings that are economically more visible than a collection of non-market goods and household duties, appear to be given higher social valuation. The higher gender discrimination was found among those landless families in which boys were involved in socially visible and recognised earning activities whereas the girls were engaged in procuring goods from common property resources (CPRs) although the total time spent on both activities did not differ much between the sexes. Epstein (1973), citing the case in Karnataka, notes that with improvements in economic conditions in small peasant households, the women members were withdrawn from productive work in the fields. The result was that the marriage price of socially perceived unproductive women members increased, although they had simply switched their work from the fields to the indoors. In most villages in Punjab, Himachal Pradesh, Karnataka, Kerala and Tamil Nadu,

the original practice of paying a bride price has now been replaced by ever-increasing dowry payments (Epstein, 1973; Horowitz and Kishwar, 1982; Venkatramani, 1986) that may have strengthened the existing anti-female bias within the family across the country.

The situation in eastern India, particularly in West Bengal, is different from that experienced in northern and southern India. In West Bengal, landless scheduled-caste women seldom work in fields. In marriage ceremonies these families practise the same dowry system as the well-to-do upper-caste families. Hence anti-female bias in landless scheduled-caste families is not of recent origin in West Bengal.

INTRA-FAMILY DISCRIMINATION

Although it is assumed that the total income generated by a family, and the assets owned by it, would be shared equally by all members of the family, the growing evidence (Agarwal, 1989) indicates the presence of (i) gender based inequalities in the distribution of resources for fulfilling basic needs; (ii) differences in household spending patterns, with women's earnings in poor households going towards the family's basic needs much more than men's; and of (iii) a strong link in poor households between the nutritional status of children and their mother's earnings.

Most rural health surveys record a much higher incidence of illness among women. It is also noted that when women become ill, they do not receive medical treatment as promptly as men receive during their illness. More women than men receive no treatment (Dandekar, 1975), and fewer girls than boys receive aid in the first 24 hours of their terminal illness (Taylor and Faruque, 1983). In a study on intra-household food allocation (Harris, 1986), it was found that adult women, adolescent girls and small female children receive less vitamins and minerals through food allocations in both north and south India and also receive less calories and proteins in parts of north India than their male counterparts. Prasad et al. (1981) in a survey in Bihar found that nearly 90 per cent of the landless labourers interviewed felt that they did not get enough food and over half suffered physically from malnutrition in varying degrees. During crisis periods such as floods, malnutrition was found to be higher among girls than boys.

Despite considerable difficulties encountered in obtaining paid employment, women in poor households often contribute a much larger proportion of their exchange income than men to the family's maintenance. This was found to be the case in Tamil Nadu, Kerala and in West Bengal (Mencher and Saradamoni, 1982). Apart from this contribution, the goods collected by women from common property resources and forests also are used for the

family's sustenance. In general, compared with men, women spend a very small proportion of their income on their personal consumption.

The type of agricultural work undertaken by women also exposes them to greater risk than men. Thus during the rainy season, rice planting, which is done mostly by women, can expose them to intestinal infections, arthritis, rheumatic joints, leech bites, and so on (Mencher and Saradamoni, 1982) and gynaecological infections. Furthermore, because of the almost total absence of leisure time from their daily routine, poor women are more susceptible to disease than men.

Women's grassroots response against male alcoholism in Himachal Pradesh in the 1980s brought out into the open the nature of the oppression and violence to which poor women are subjected both within the family and outside it due to male alcoholism. Since the cost of a bottle of country liquor is significantly higher than the minimum wage, a household with a male drinking problem tends to spend considerably less on food, education, health and clothing than one without the problem. Women and children are quite often beaten by their drunk husband or father.

Some social taboos against low caste people affect women more than men. Thus, for example, there is a taboo against the use of village ponds and wells by Harijans. But this taboo especially affects women who bear the responsibility of fetching water.

Although it is generally acknowledged that the working day for poor women in India ranges between 12 and 16 hours, there are very few detailed studies on the time allocation of women between various activities. One study (Jain and Chand, 1985) of three villages in West Bengal and Rajasthan covering 127 households over 12 months found that women in the age groups 19–34, 34–44 and 44–70 spend longer hours than men in a variety of activities. Roy and Tisdell's study (1993) also found that women suffer more frequently than men from common waterborne diseases. Men receive better and prompter medical treatment than women. They eat better food and in larger quantities. Women take their meals only after men have eaten, and eat what is left. Women work longer hours than men and wage rates of women labourers are less than that of men labourers for the same kind of job.

Gathering activities such as collecting fuel, water and vegetables which absorb a significant part of women's time are interwoven with other tasks to the extent that men are not even conscious of these tasks which constitute an important contribution to the family's subsistence. Thus studies on intra-household discrimination seem to emphasise the following aspects of discrimination:

1. The bias against women in food consumption within the household has resulted in greater malnourishment of female children *via-à-vis* male

children regardless of economic class and in greater discrepancy in weight relative to height between men and women irrespective of economic class (Horowitz and Kishwar, 1982). Calories consumed by women are less than that recommended by the Indian Council for Medical Research and significantly less than men. Women also consume less than their energy expenditure in fieldwork and domestic duties. This deficiency affects the health of pregnant and lactating women.

2. In terms of health care, the discrimination against women continues to persist. The period of delay in attending to an illness is much greater for women than for males and the number of hospital admissions is higher for men than for women. While all rural women tend to suffer from such gender-based inequalities, landless female labourers and female-headed households have to put up with additional gender-based discrimination. Although landless female labourers are the largest and the most visible section of India's female labour force, and in most situations they are the primary bread-winners, they have less access than men to opportunities for employment due to the following:
   (a) Less job mobility resulting from their vulnerability to class or caste-related sex-abuse, 'ideology of seclusion' and responsibility for child care;
   (b) More limited access than men to information on job opportunities due to lower literacy rate, and less contact with the market place and access to the mass media;
   (c) Confinement to casual work in agriculture;
   (d) Lower payment received than men – often for the same task performed;
   (e) Lack of access to training to operate productivity-increasing equipment (Agarwal, 1983, 1989), and
   (f) Mode of wage payment to women, which excludes wage provisions (Ryan and Wallace, 1985).

Compared with male-headed households, female-headed households are more adversely affected by gender bias in employment and wages and, in general are found to have significantly less access to and control over land, greater dependence on wage labour for employment, a higher incidence of involuntary unemployment and a lower level of education and literacy (Agarwal, 1989).

All this gender based discrimination that significantly undermines women's capacity to achieve empowerment seems to stem from the practice of the same institutional (cultural) impediment: the 'ideology of seclusion'. Now we will discuss specifically the lack of education and property rights.

THE LACK OF EDUCATION,[3] WOMEN'S ACCESS TO EDUCATION, EMPLOYMENT, AND THE FORCE OF INSTITUTIONAL IMPEDIMENTS

Take the case of education. Education is an endowment that enables a woman to use skill and knowledge to obtain her entitlements. Due to gender discrimination embodying the 'ideology of seclusion' less attention is paid to and less emphasis is placed on the education of girls and women than on that of boys and men. As a result, women in villages and rural towns do not get the opportunity to acquire the same marketable skills and knowledge as the males.

Even if they receive the same endowment (education), it does not necessarily improve their entitlement exchange capacity due to institutional impediments, although it helps reduce the population growth in the long run by making them aware of the beneficial effects of late marriage, use of contraceptives and of having fewer children. Hence there is a clear distinction between education in general and appropriate marketable skills-based education.

It is unfortunate that in the literature on women in development and on development studies in general (including Sen's study), such a distinction does not appear to have been made and the importance of skills-based education in women's empowerment has not been discussed. Thus the failure of girls and women in general and of rural girls and women in particular to acquire the appropriate education they choose, stems from the most powerful institutional deterrent called the 'ideology of seclusion' which is the most powerful component of what we broadly term 'cultural impediments'. Furthermore, considerable emphasis has been placed in the literature on primary education being the key to the success of women's empowerment process. Therefore, the primary school enrolment ratio has been used as a proxy to test the success of government's primary education programmes. But in India, in rural areas, the actual enrolment ratio in primary schools generally is considerably below the ratio reported in the official statistics. This situation exists because of certain cultural impediments, which include the lack of a work ethic, or sense of responsibility or duty on the part of teachers who stay away from school during school hours in order to carry on their private business; and on the part of government officials who fail either to implement the rules and regulations properly or to penalise the teachers. Also even when the teachers are present, they may not be discharging their duties – although the students are most likely to pass their subject as they take private coaching from their subject teachers by paying monthly fees. Even when the teachers impart adequate knowledge to their students, the education they obtain is

mostly generalist and therefore does not help them in their empowerment process.

It should however be noted that female teachers possess a better work culture, greater sense of responsibility and are more motivated than male teachers.[4] However in rural areas in India most primary schools are co-educational and are dominated by male teachers.

Parents also do not want to send their children to school owing to these above noted factors as well as to the fact that the opportunity cost of sending children to school is loss of family income. These are all part of the same 'cultural impediment'. Hence education does not always lead to the success of women's empowerment process in the presence of the cultural impediments. Sen's theory and other studies on women in development do not seem to have recognised this fact.

WORLD BANK STUDY

A World Bank study (1991) found that the following factors impede women's progress towards achieving higher education:

1. Parental and societal attitudes towards the education of their daughters are important factors in the non-enrolment and higher dropout rates of female children in families which have very limited income, assets and low rank in the caste and occupational hierarchies. The parents of these girls are illiterate or semi-illiterate agricultural labourers, small farmers, and artisan families, or are urban slum dwellers working in the unorganised sector in low-status jobs.
2. Since the level of family income is very low, the children of these families, especially girls, are required to work both within and outside the home. Banerjee's study (1989) found that between 1971 and 1981 there was a sharp increase in female child labour in rural areas. While the absolute number of boys in the rural labour force went down by 8 per cent, the number of girls increased by 30 per cent.
3. The direct costs of education also deter families from sending their girls to school. Although there is no tuition fee for primary education in publicly funded schools, other expenses such as the cost of books, other learning aids, uniforms and transport can impose quite a heavy burden on poor families. Although some state-administered programmes offset some of the costs to scheduled castes and tribals, they do not cover all poor families.
4. Another important factor is the social perception about the return expected from girls' education. Since a girl once born will eventually

get married, there is no long-term return expected from investment in girls' education. Hence for their future role as mothers and unskilled worker, girls require little formal education.

5. Also the way school systems are run, do not seem to provide an incentive to parents to send their children to school. The inconvenient location of schools, absence of teachers, the irregular functioning of schools, the lack of basic facilities such as blackboards, benches, tables, chairs and so on, and single-teacher schools, exert a demoralising influence on parents' minds.
6. Also there is a particular scarcity of female teachers that affects girls' attendance at schools.

Although the research (Schultz, 1993) indicates that investment in girls' education yields higher returns, gender disparities appear to be high in household expenditure on education. Among the students receiving free tuition in primary education, girls are better placed. But the number of boys receiving partial or total exemption from payment of tuition fees is proportionately higher than girl students. A study by the National Sample Survey Organisation (NSSO, 1991) found that the number of scholarships received per student in rural areas was considerably lower for girls than for boys. A study by the National Council of Applied Economic Research (NCAER, 1994) found the presence of discrimination against girls in household expenditure on education.

However, extensive fieldwork in rural hinterlands and in tribal belts in West Bengal and private discussions and personal interviews with tribal people reveal that there are other forces that work against women's empowerment that the World Bank failed to recognise.

THE COST OF EDUCATION AND THE INFORMAL MARKET FOR EDUCATION

The cost of education is high because there is gross inefficiency in the use of funds. A substantial part of the budget allocation for education is spent on wages and salaries of academic and non-academic staff in primary, secondary and tertiary institutions. A vast proportion of total income of educational institutions is derived from government grants, which in 1985–6 accounted for 87.7 per cent of total funds available for expenditure by educational institutions (Government of India, 1995).

Primary and secondary education is the responsibility of state governments. Table 11.1 shows that the total state government expenditure on education was only Rs 68.8 billion in 1984, accounting for 22.7 per cent of

Table 11.1 Expenditure on education by state governments

	1984	1985	1986	1987	1988	1989	1990	1995	1997
Total expenditure of all state governments (Rs billion)	302.5	348.9	402.9	475.1	541.1	619.8	740.5	1493.3	1903.1
Total expenditure on education (Rs billion)	68.8	82.2	91.7	107.0	126.8	157.0	183.4	343.1	449.5
Percentage on education	22.7	23.6	22.8	22.5	23.4	25.4	24.8	23.0	23.6

Source: IMF (1994, 2000).

total expenditure and it reached Rs 1903.1 billion in 1997, accounting for 23.6 per cent of total expenditure of states.

Hence the higher cost of education cannot be due to low level of expenditure by government on education. It is due among other things to the fact that in India, although formal state schools, which absorb the overwhelming bulk of students, represent the formal education market, very little education is provided in these schools particularly in rural areas. Teachers in both rural and urban areas tend to provide the same education in the secondary education market through large-scale private coaching. Thus while teachers earn comfortable salaries in the primary market and more than 100 per cent of their salaries in the informal market, the parents are forced to bear the cost of enrolment in the formal market and the cost of teaching in the informal market. Small farmers, tribals and scheduled caste families as well as low-caste families doing odd jobs in the informal sector in towns cannot afford such expenses. School and college teachers also belong to powerful unions and no government dares to flex muscles against these unions. Hence the degeneration of the educational system continues (revealed through private conversation with tribal elders during fieldwork).

Contrary to the general belief that households do not spend much on primary education which is being provided free to every student, recent studies (NCAER, 1994) found that households spend a considerable amount on primary education. The NCAER (1994) study covering 15 000 households in 15 major states in India found that households incur huge expenditure on elementary education.

PREVIOUS FIELD STUDY, 1993

A 1993 field study by the present author reveals that 93 per cent of all women interviewed agreed that lack of technical skill and knowledge limited the scope for employment of educated females. Also 79 per cent of them agreed that if guidance and opportunities were given to them, they would have completed technology-oriented degrees. Fifty-six per cent of the respondents agreed that men in the family were given such guidance and help. Furthermore, more than 97 per cent of them agreed that information about the availability of technology, adequate facilities for training and credit to obtain and utilise technology would improve their access to technology that in turn would help them become economically independent.

Through private conversation, a number of respondents also revealed that even if girls and females in rural areas (villages and rural towns) receive education appropriate to their empowerment, they would be unable to utilise their education because the 'ideology of seclusion' would prevent them from obtaining information about employment opportunities, and from moving out of the confines of their surroundings in search of effective employment. In the same 1993 study, more than 97 per cent of respondents agreed that equal opportunities with males are necessary for the employment of females. Thus even if all the factors conducive to the progress of education and thereby to the empowerment process of rural women are present, derogatory customs embodying gender discrimination do prevent girls and women from achieving success in their empowerment efforts. They also mentioned that the type of education that girls and young women receive in villages and rural towns does not depend on what they consider appropriate to their empowerment process but on what is available within the proximity of their towns (even if that is inappropriate) and what family elders force them to take. Apart from the 'ideology of seclusion', the poor economic status of rural families also prevents them from sending their female children to institutions located in distance places.

FIELD STUDY, 1994–5

The present author undertook another field study in a tribal area in rural West Bengal in 1994–5. It consisted of one survey of all girl students in class X in a secondary school. These students consisted of both tribal and non-tribal girls. The second survey interviewed all the female university graduates in that tribal region. This tribal region is in Midnapore district, which is a part of the Bengal, Orissa and Bihar tribal belt in India.

Field Survey I: Survey of all Students in the Top Class in a Girls' Secondary School in a Tribal Region in Midnapore District

The objective was to find out (i) the reasons for pursuing their current study; (ii) the influences of derogatory customs on the type and level of education they obtain; (iii) the effect of the 'ideology of seclusion' on the prospect of obtaining employment; (iv) the influence of customs on marriage; and (v) the severity of the force of 'classic patriarchy'.

All students in grade X, the exit year for students for that school, were interviewed. After completing grade X, the students would have had to enrol in a higher secondary school or a college to complete grade XI and XII. These institutions are located in distant places. Some of the girls would have had to travel long distances every day or to stay at the school hostel. Such a move would have involved substantial expenditure on the part of the families and violated the rule of the 'ideology of seclusion'. The total number of students interviewed was 90, of whom 31 were from tribal and scheduled caste families and 59 from upper caste families.

The results of earlier fieldwork summarised in previous paragraphs have already indicated that the type of education that women and girls were getting was not suitable for obtaining employment and therefore for the success of the empowerment process. This fieldwork gives a better picture of the usefulness of education that girls in the rural hinterland are receiving. Questions were asked as to (i) why these girls were pursuing their studies; (ii) whether they would have pursued higher studies at a distant institution if the 'ideology of seclusion' was enforced on them and also if it was not enforced on them; (iii) whether derogatory social customs greatly influence the type of education they receive; (iv) whether they prefer late marriage as they want to pursue higher studies and to acquire greater skills for obtaining employment; (v) whether the customary practice of marriage at an early age prevents them from realising their full potential; (vi) whether being female prevented them from obtaining their preferred education and (vii) whether discontinuing the traditional system of arranged marriage is essential for the fuller development of women and society. Since they are women, they are prevented from undertaking job-orientated education and the enforcement of the 'ideology of seclusion' on them has kept their latent qualities relatively underdeveloped. As a result they are unable to follow an independent profession. Most graduates want to have the freedom to move freely to meet and communicate with people in order to utilise opportunities for their empowerment.

The vast majority of female graduates, irrespective of their caste differences, gave affirmative responses to all the questions. It therefore seems that increasing the endowment set of these women will not lead to the entitle-

ment exchange and removal of poverty until the social and institutional hindrances are removed.

A number of social and religious customs act as very powerful deterrents to women's empowerment: arranged marriage, the payment of dowries and other limitations on women's freedom are hindrances that hamper social and economic progress in the country.

To gauge the relative strengths of some important affirmative responses, the ranking of such responses has been presented in descending order in Table 11.2 with a graphical representation in Figure 11.1. It can be seen from the table that the question 'obtaining employment through education is important' received a 100 per cent affirmative response.

It is evident from Table 11.2 and Figure 11.1 that the availability of appropriate education and the removal of gender discrimination assumes crucial importance in women's empowerment.

Table 11.2 Ranking of affirmative responses

Responses	*Ranking of affirmative responses in descending order
Obtaining employment through education is important	10
Gender discrimination is the biggest hindrance to empowerment	8.9
Due to early marriage, full potential is not utilised	8.9
Freedom of movement is necessary	8.1
Late marriage is preferred	7.6

Note: *For 100 per cent the ranking is 10, which is highest.

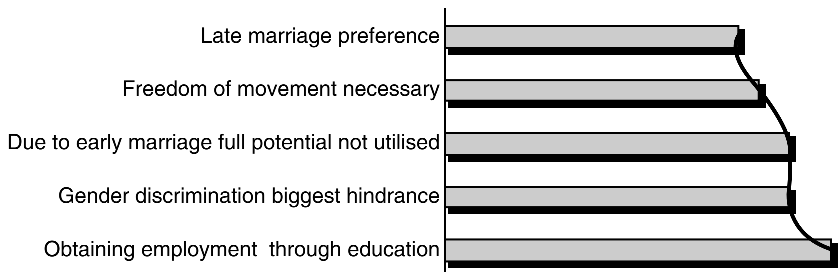

Figure 11.1 Some important affirmative responses

NON-FORMAL EDUCATION, COMMUNITY EDUCATION AND DEROGATORY CUSTOMS

The same World Bank study (1991) admits that the 'enabling' quality of education that allows women with primary and middle school education to enter secondary and tertiary occupations more easily than illiterate women, may be offset to some extent by the lesser 'need to work' among women in middle and high socioeconomic groups as well as by traditional purdah practices common among the middle class. Significantly a larger share of literate and educated women than illiterate ones enter into occupations outside the home, classified as 'non-household' occupations in the secondary sector. Even modest levels of education decrease rural women's participation in the primary sector. The study argues that female education in India must be enhanced through both the formal school system and non-formal schemes. Adults and school dropouts are a critical target group in addition to younger school entrants. Also it further argues that improving the quality of primary education would go a long way to increasing girls' participation. At the same time, non-formal education must be directed at girls whose need to work deprives them of the opportunity to attend formal school and receive the equivalent of five years of schooling. Such an education can encourage greater participation through the provision of incentives to girls. Furthermore, the provision of basic literacy and numeracy skills to women will enhance economic productivity and welfare. Production-oriented skills training can also enhance women's earning capacity and open up new avenues of employment.

However gender discrimination is enforced not only on women and girls in 'upper caste' families but also on women and girls in 'scheduled caste' and 'scheduled tribe' families. Therefore, non-formal and formal education ought to be combined with community education of all village and family elders to convince them of the urgent need to discontinue the practice of the 'ideology of seclusion'. The World Bank's assessment of this problem of women's education in India overlooks the urgent need for the removal of institutional impediments in the education of girls and women. Without this, no real progress can be made towards the empowerment of women.

SOME COMMENTS

From the two surveys conducted in a tribal area in West Bengal, it is evident how strong the cultural impediments are. In spite of having a proper education, women fail or even cannot try to gain employment. Also as discussed earlier in the text, in the south Asian context the enrolment ratio

cannot be used as the most important indicator of progress in girls' and women's education, particularly in rural areas of India.

One of the biggest cultural impediments to improving women's status is the marriage factor. In both the surveys conducted, women expressed strong preferences for late marriage. They prefer to have a late marriage so that they can further their career. The second survey pointed out very strongly that all of them want to get a proper job. However, being women, they are automatically subjected to the 'ideology of seclusion' and it is difficult for them to follow some independent profession or start some commercial venture. On these points the opinions are unanimous irrespective of caste and creed. This point has been confirmed with the paired sample t-test conducted within the various groups, which clearly showed that there is absolutely no difference in the opinions among the three groups, the 'scheduled caste', the 'scheduled tribe' and the 'upper caste', regarding their preference for late marriage.

Furthermore, Table 11.2 indicates that although the overall opinions of the three groups are the same, a difference is noticed in the overall opinions of the scheduled tribe and the upper caste, due to significant differences in their socioeconomic status and cultural backgrounds.

Another point which became obvious from the two surveys is that although most women prefer a late marriage, they are aware of its consequences. Late marriage is looked down upon strongly in rural India. If the women are not married at an early stage they will be subjected to various types of humiliation including taunting by youths, gossip by neighbours and criticism from elders.

Even the parents are subjected to social pressure owing to the late marriage of their daughter. The pressure might become so high that to the parents the offspring seems to become more like a burden, to be rid of by marriage. Under those circumstances marriage becomes perhaps the most important achievement in both the girl's and her parents' life.

Both married and unmarried women are restricted from free movement in the rural hinterland. Even travelling too far to gain education is looked down upon. As a consequence, the prospect of getting a job becomes remote even with proper education. However in most cases the education that women obtain does not seem to be appropriate due to the 'ideology of seclusion'. For example when a technical qualification is perhaps essential to get a job, an education best suited to social and cultural norms are provided. As a consequence, even a graduate degree becomes somehow irrelevant for obtaining a job. In some cases, a woman cannot even take up a job if it is offered at a place at some distance from her home.

The 1994–95 field study in West Bengal shows that cultural factors, including social and traditional factors, do play a major role in the improvement

of women's economic condition. The Gender Empowerment Measure and the Gender Development Index lose much of their significance in the rural hinterland of India. The endowment factor definitely increases due to education; however, there is no exchange entitlement for such endowment factors. The measurement of women's welfare by GDI and GEM, especially in the rural sector, can be termed at best incomplete and insufficient. This section concludes that there is the necessity for a social index which will measure the various cultural impediments, with 'ideology of seclusion' perhaps being given the heaviest weight.

THE CASE OF PROPERTY RIGHTS[5]

First, it is necessary to know why property rights are important for women's empowerment in rural India.

Why are Property Rights Important?

Women's socioeconomic status can improve if they undertake economic activities which are socially recognised. But as mentioned before, to be socially recognised, economic activities have to be socially visible as well. For activities to be socially visible, they cannot be undertaken within the confines of the home. Hence, although many household chores undertaken by women contribute to the family's sustenance, they are not recognised as economic activity. A person's work in the fields, whether as the owner of the property or as hired labour, is socially visible and therefore recognised as economic activity. A person's social status in rural India is judged by the number of Bighas (1 Bigha = 1/3 acre) of land that person owns. No other assets such as cows, goats or jewellery are as important as land because land is a more permanent source of income than all other assets. Ownership of larger amounts of land as property means that the person's income will be higher and the capacity to spend on consumption of food, other necessities such as education, health care and housing and so on will be higher. Also a person owning a property has a long-term interest in preserving the fertility of the land and therefore in investing in that land. If women simply work on someone's land as hired labour or on family land as unpaid labour, they do not have any opportunity to invest on the plot of land and cannot have a significant voice in the family's expenditure plan.

For the sustainable development of agriculture and the preservation of forests and other natural resources, granting landownership rights to women is important. Women are generally conserving and not destructive

of nature. Therefore the chance of the adoption of sustainable agricultural practices is greater under female than male ownership of land. Also rights to arable land enable women to reduce their reliance on forests for providing sustenance to their families. Less use of forests slows down the pace of degradation of forests. About 20 per cent of India's households are female headed. Without property rights such heads will find it difficult to maintain their families. Since there is no social security system in India, property rights enable the aged and infirm to survive. Agarwal's (1994) arguments in support of property rights for women can be grouped into three broad categories: a welfare argument, an efficiency argument and an equality and empowerment argument.

Welfare argument

As mentioned earlier, land rights reduce women's own as well the household's risk of poverty and destitution. It also can reduce the severity of anti-female bias that exists in households in varying degrees in the distribution of food and other necessities across all regions in India. According to Harris (1990), intra-family gender bias can be noticed in terms of one or a few such indicators as malnourishment, mortality, hospital admissions and healthcare expenditure. However, gender discrimination against women and female children in intra-family distribution of food and other necessities seems to be gradually diminishing for poor families in rural areas in eastern India due to the spread of television, adult education (community education), women's employment, women's active participation in women's employment generation committees (DOCWRA committees) and in Anchal Panchayats.[6] Various studies also reveal that while men keep a sizeable portion of their income for their personal consumption (liquor, tobacco, clothes and so on), women spend almost the whole of their income on family needs[7] (Mencher and Saradamoni, 1982; Mencher, 1988; Dasgupta and Maity, 1986). However, the situation seems to be changing slowly. In Orissa in some areas tribal women under the Development of Women and Children in Rural Areas (DOCWRA) scheme keep a certain portion of their income as savings and also spend something on their own needs.

Nevertheless women continue to spend most of their income on their family needs. Kumar (1978) and Gulati (1978) find that the positive relationship between income and children's nutritional status appears to be stronger for the mother's income than for the father's income. Among the marginal farmer households, the mother's income from the output from her home garden appears to have a strong positive effect on child nutrition (Agarwal 1994a, b). Hence to ensure that the physical wellbeing of a woman and her children will be well looked after, a woman needs direct

access to income rather than indirect access through others such as her husband or other male members in the family.

Hence, for direct access to income, land rights are of crucial importance. While creation of other employment opportunities is also necessary for women's access to income, land is a permanent asset and therefore acts as a permanent security against poverty and in case of divorce, desertion, separation or widowhood (Agarwal, 1989). During a recent interview[8] with adult males in a Kandh tribe in Phullbani district in Orissa, the adult males said that the land titles are held by the male head and it is passed on, after his death, to the eldest son and not to the wife. When asked 'what happens to the wife of the head?', they answered 'sons take care of their mother'. When asked 'What guarantee is there that they will take care of all her needs and look after her?', they answered 'yes, they will take care of her'. In other words, there is no security in the absence of land for the aged and the infirm. In other words, without property, children do not look after their parents well (Caldwell et al., 1988). A slightly different picture emerges among Santals in West Bengal. One male head may hold the *de jure* land title, but after his death the landed property is passed on to his sons with their mother's consent. The son who looks after the mother usually gets a larger share of the land. In this case, the mother can exercise some control over the property.[9] The owner can use a plot of land for multifarious activities such as growing crops, fodder, trees, keeping livestock, practising sericulture or using it as a collateral to obtain loans from the banks. While land rights are important for women in poorer households, in richer households it is also important for women to have land rights particularly after a marital breakdown. Even if the plot of land given to a woman is small, on welfare grounds women need to be given land rights.

Efficiency argument

Women in India do cultivate land but others hold the titles. Female heads of households have the full responsibility of cultivating the land and performing other tasks for maintaining the family. If the original title of the land is in the name of the husband, then in the absence of succession certificates issued by the court, the de facto title goes to the eldest son. Agarwal (1994b) found that in Rajasthan, widows were cultivating plots given to them out of joint family estates as part of their inheritance claims to their deceased husband's land. Efficient cultivation of land requires investment, which requires money. Land titles can be used as collateral to obtain credit from the financial institutions. Also with land titles women can have greater access to technology and information on productivity increasing agricultural practices and inputs, not any of which are easily available to women

due to the gender bias in their delivery (Dasgupta, 1977; Byres, 1972; Agarwal, 1985).

Existing evidence suggests that land redistribution from big to small farmers, would probably increase output (Agarwal, 1994b). Land in women's names will lead to the greater preservation of ecology and the environment (Agarwal, 1992). Since lack of women's employment is a primary factor in the decision of poor rural families to migrate to cities (Roy, Tisdell and Alauddin, 1992) giving land rights to women can slow down the pace of such migration and reduce the pressure on urban infrastructure and other resources.

Equality and empowerment arguments

Empowerment is a process by which women can gain power to significantly reduce the forces of institutional deterrents to their development (Agarwal, 1994b; Bookman and Morgan, 1988). Equality is achieved when women earn the capacity to challenge the existing power relations that place them in an inferior position to that of men. Gender equality is necessary to achieve social justice. Progress towards gender equality and empowerment can be greatly justified if women attain economic independence. Granting land titles to women can help them attain such economic independence. The demand for women's land rights is justified as it provides them with economic security and respectability in their marital relations. In the absence of land rights, women can be badly treated by their husbands (Manimala, 1983).

Other male members of the family give women with land titles better treatment as well. Agarwal (1994b) noted that widows with land living with their adult sons were treated with much greater respect and consideration than those who were landless and economically dependent. During recent fieldwork in Orissa and West Bengal, the present author[10] was told that irrespective of whether the mother has land titles in her name or not, sons treat their mother with respect and take care of her needs after their father's death. But within the family, land titles help women attain empowerment and equality in status with their husbands. Outside the confines of their homes, their relationship with the rest of the society also improves (Mises et al., 1986). As far as women's effective participation in the village-level decisionmaking process is concerned, land rights alone may not be enough. Nevertheless it may facilitate that participation. Thus it appears that property rights, particularly land rights, are a far more important pre-requisite than all others for women's empowerment.

In this section we have reviewed the essence of current debate on the need for women's property rights. Much of the discussion has been concentrated on women's legal rights to land, as land is considered to be the

most important form of property. The next section examines what kind of property rights are important.

WHAT KIND OF PROPERTY RIGHTS?

The legal right to land in absence of a customary right has no teeth. The customary right imparts social recognition to the legal right. Hence the legal right to land needs to be accompanied by the customary right. In south Asian countries, inheritance practices are mostly patrilineal except among certain small communities such as Garos, Khasis and Lalungs in north-east India and Niyars and Tiyyars in south India in which these practices are matrilineal. In general, in India as well as in other parts of south Asia, legal rights and control rights on land have been vested in men. Although women in rich patrilineal families (northern, north-west, central, western, eastern, and south-eastern India) sometimes owned and had dealings in land, their degree of control was rather limited. This is because the support of the local communities, which evolve and transform such customary rights, is vital to the enforcement of such rights. Although the state is recognising the inheritance rights of females as individuals, local communities govern the marriage customs, which grant customary rights to women. These customs have not changed.

CURRENT STATE OF CUSTOMARY ACCESS TO LAND

Agarwal's (1989) study presents an interesting picture of the extent of women's customary access to land. The study comprising 145 village communities across all regions of India found that in 131 or 90.34 per cent of communities the land access pattern is patrilineal. The result of this highly significant study is presented in Table 11.3.

It can be seen from Table 11.3 that under the norms of land inheritance only in 10 communities do matrilineal customs determine women's access to land and in only one community bilateral custom determines it. These two categories account for only 8 per cent of the total of 145 communities examined. Under the third section illustrating the pattern of actual possession under patriline, it can be seen that, out of 145 communities, in only five communities do daughters in sonless families, and in only eight communities do wives as widows, come into actual possession of land. These account for only 9 per cent of the total communities studied.

Table 11.3 Customary access of women to land

Aspect/region	Northern		Central		Eastern		North-eastern		Southern		Total cases	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
Norms of land inheritance												
Communal ownership	–	–	–	–	–	–	2	10	1	2	3	2
Patrilineal	53	100	16	100	14	100	14	74	34	79	131	90
Matrilineal	–	–	–	–	–	–	3	16	7	16	10	7
Bilateral	–	–	–	–	–	–	–	–	1	2	1	1
Access via specific customs under patriline												
As daughters in sonless families	16	30	7	44	6	43	–	–	5	12	34	23
As widows	4	8	2	12	2	14	–	–	–	–	8	6
Usufructuary rights only	3	6	2	12	2	14	2	10	3	7	12	8
As dowry	–	–	–	–	–	–	–	–	6	14	6	4
Mention of actual possession under patriline												
As daughters in sonless families	1	2	2	12	–	–	–	–	2	5	5	3
As widows	4	8	2	12	–	–	–	–	2	5	8	6
Usufructuary rights only	–	–	–	–	1	7	–	–	–	–	1	1
Total number of communities examined	53	100	16	100	14	100	19	100	43	100	145	100

Source: Agarwal (1989).

IMPEDIMENTS TO EXERCISING LAND RIGHTS

According to the ancient Hindu law, women could at best enjoy a lifelong interest in ancestral property only as a widow or as a daughter in a sonless family. Islamic law gives only partial recognition to women's inheritance rights to land but customary law prevents women from exercising their rights in agricultural land (Agarwal, 1988).

Even in those cases where women's inheritance rights to land is recognised, the condition that a woman must stay in her parental home or her husband must visit her regularly cannot be met if her marital home is too far away from her natal home. Hence even if the right exists, it cannot be exercised. Hence long-distance marriages, which are most commonly seen in northern India, prevent a woman from exercising her customary rights to land. Furthermore, in order to maintain a good relationship with her brother in her natal home as a source of help and support in times of need, the woman usually hands over claim to the property to her brother.

During recent fieldwork among Santals in Sadanandapur village in Midnapore District in West Bengal, the present author was told that if a widow has land in her name, and has a son and a daughter, she gives a share of the property to her daughter. But after her marriage the daughter usually gives up her right to land in favour of her brother, particularly in cases of village exogamy.

In a case where a woman decides to exercise her right to land, by taking legal action, male members in her natal home may take various courses of action such as finding loopholes in the current law, forcing her father to disinherit her, or forging her father's will after his death (Parry, 1979). They can also try to convince the revenue officer that her marital home where she lives is too far away from her natal home and therefore she cannot exercise her right (Mayer, 1960).

In other cases when a woman wants to exercise her right, male members in her natal home may try to harass her and may also start expensive legal proceedings against her which can force her to give up her right (Agarwal, 1989).

In other cases, particularly in Bihar, women have been beaten and even murdered under the false pretext of witchcraft to prevent them from exercising their rights to land (Mintern and Hitchcock, 1966; Kishwar, 1987). The male bias in official policies and programmes strongly affects legal decisions and new policy formulation by the government. As Manimala (1983) observes, even after receiving the government's permission to have land titles in their names, women in two Rajasthani villages were prevented by the officials from formally registering land in their names on the pretext that land titles can be granted only to men as they are the head of the family. It is also surprising to note that such a bias also has been found among some

matrilineal communities such as the Garos in the north-east – especially after the land privatisation programme began to be implemented (Majumdar, 1978).

OTHER DIFFICULTIES IN EXERCISING LAND RIGHTS

Even when women do possess legal and customary rights to land, they may still find it difficult to exercise those rights for the following reasons:

1. Women living too far away from their natal homes under village exogamy find it difficult to exercise their customary rights of inheritance as daughters in their natal villages.
2. The 'ideology of seclusion', by restricting women's movements to the surroundings of their homes, prevents them from obtaining necessary information on agricultural politics, obtaining inputs and selling outputs (Agarwal, 1989). Although Santal women are also bound to some extent, by the 'ideology of seclusion' they are free to go to the market to purchase inputs and to sell their outputs.
3. The number of villages to be covered by an extension agent is usually quite large and these agents normally visit quite infrequently even those villages which are within a short distance from the Block Development Office. Hence, those villages, which are located in remote areas, usually miss out on the services of extension agents.
4. Even where the force of 'classic patriarchy' is weak and information on agricultural practices is easily available, large numbers of women cannot utilise this information owing to their illiteracy.
5. Also women's access to extension agents is further limited by the fact that the number of female extension agents within the country is very small.
6. Without loans, women would experience difficulties in obtaining inputs but loans cannot be obtained from the banks without land as collateral. Even the village moneylender refuses to lend money to women because men are perceived as being more able to repay the loan (Agarwal, 1989; Roy and Tisdell, 1993b).
7. Taboos, which prevent women from ploughing the land, greatly limit the capacity of a poor woman or of a female head of the household to cultivate the land independently. The force of this taboo is quite strong among all tribal and non-tribal communities in India. Among the Oraon tribals, there is a taboo that if women plough the field, there will be serious consequences (Dasgupta and Maity, 1986).

8. Hence, women would have to rely on male labour to effectively exercise their legal and customary rights to land, but male labour may not be available at the right time or in the right numbers because they are usually accessed first by male-headed families. Hence, by the time male labour becomes available for ploughing and other tasks, the appropriate time for cropping might have passed.

The discussion therefore has shown that the customary right appears to be more important than ownership right. In a patrilineal community, male heads hold land titles. Where such heads died a long time ago, in absence of succession certificates, male children usually have customary access to the land. As we have noted, where female children do have customary access to land, they usually give up such rights in favour of their brothers. Granting women legal rights to land would require a generational change in the cultural environment within which we live. Parliament, judiciary, and law enforcement agencies that can change the institutional environment affecting women are all male dominated. Laws passed by members of parliament reflect their own social perception of women and of their land rights. The judiciary simply gives validity to that law and the law enforcement agents simply implement these laws. Such institutional impediments cannot be removed so easily. Even when a woman's legal right to land is upheld by the court, she may be required to pay sufficient bribes to law enforcement agents to enforce her legal right.

In such a situation what seems to be more important is to ensure that measures are taken to remove the impediments to women exercising their customary rights. What also should be noted is that the issue of property rights (legal and customary rights) has to be examined and understood in the wider context of women's economic independence.

LAND RIGHTS IN THE WIDER CONTEXT OF ECONOMIC INDEPENDENCE

Very few women possess land rights and very few women have the ability to exercise those rights because of gender restrictions and lack of financial capacity to invest in land. One way of overcoming the problem of lack of financial capacity is for owners of adjacent plots of land to jointly undertake investment (Agarwal, 1997). Unfortunately such a proposal may not work, if all the owners of adjacent plots are not women. Even if all owners are females, the group action may not take place if owners belong to different castes or come from different villages. One way of overcoming the problem of lack of legal ownership of land, as Agarwal (1997) suggests,

would be for women to jointly purchase or take lease in land and jointly cultivate it. However, for such a scheme to work, women need to have some savings of their own and the help of some organisations. In south India, where the scheme has been successful, the Decan Development Authority and an NGO helped the women. But there are other parts of rural India where very few women's cooperatives exist and very few NGOs operate. What seems to be more feasible for the government is to grant group rights to poor rural women. Under this scheme, each woman in the group would have use rights in the land but would not be able to sell it individually. Daughters and daughters-in-law who live in the village would enjoy usufructuary rights. Daughters who get married and go to their marital homes can establish similar rights there. It is clear from this discussion that social dynamics (group action) and help of an outside agency (NGO) must be present for these schemes to be successful.

However as mentioned before, group action can only be initiated relatively easily if the poor women come from the same caste and from the same locality (para) of the village.

While the importance of property rights in women's empowerment is extremely important the reality is that millions of poor women, particularly of scheduled tribes, may never get any land rights simply because very few tribal families have sufficient land. For the economic empowerment of these women, non-agricultural land-based opportunities for employment will have to be created. Tribal women use forests to collect non-timber forest products. They manufacture plates and bowls from sal leaves. Their method of collection of raw materials, the process of production, and their method of marketing their production need to be more organised and efficient. Tribal families make various kinds of baskets from bamboo, but since each family buys only a small amount of bamboo, the cost is quite high. When selling their products, the tribal women compete with each other in the market thereby forcing their prices down. There is no group action in buying raw materials, or in producing and selling output.

Similarly, the process of collecting leaves from date trees, of making mats and of selling the mats in the market are the responsibility of individual tribal woman. These women need loans at low interest rates. No attempt has been made to adopt a group approach in all these activities. These are the traditional employment-generating activities in which tribal women are engaged. More sustainable employment-generating activities need to be found. Adopting a group approach to each type of activity is crucial to the success of any employment-generation programme. NGOs play an invaluable role in all these activities. Thus if helping women to attain economic independence is our goal, then acquiring property rights is only one means

to that end and the importance of property rights in the wider context of women's economic independence and empowerment lessens somewhat.

FIELDWORK, 1999–2000

To find out what other institutional impediments are affecting poor rural women's progress towards economic independence and how important they are in the wider context of women's empowerment, a field survey was conducted in late 1999 and early 2000 in four villages: Bandhgora, Janakpur, Banskona and Sadanandapur in Midnapore district in West Bengal. A sizeable proportion of the total population of this district, which borders Bihar and Orissa, belongs to scheduled caste and scheduled tribe households with very little assets including land. This border region is also one of India's most well-known tribal belts. Of the four villages, Bandhgora and Janakpur consist of Santal families, Banskona consists of scheduled-caste families and Sadanandapur consists of Santals (a scheduled tribe), scheduled-caste and upper-caste families. The survey covered all the families of each village. The wife or the mother of the male head of the family was interviewed. The results of the survey are presented below.

Summary of Survey Results

The vast majority of respondents said that male members of the family hold land titles but they have customary rights to collect forest produce. But they are unable to collect as much forest produce now as they used to 10 years ago. They also admitted that the decline in the quantity of forest produce undermines their power and influence in the family. Nevertheless in the absence of ownership rights to land, the customary rights to the use of forests and the preservation of forest resources are important for poor women's empowerment. To undertake productive economic activities individually, they need small loans from banks at low interest rates, currently not available due to lack of collateral and also help from NGOs to organise production activities. Also, they do not adopt a group approach (social dynamics) in order to solve their economic and social problems because such an approach is easier to adopt among women belonging to the same caste and the same para (neighbourhood).

Women want the implementation of a comprehensive education scheme (consisting of formal, skills-based and community education) in a comprehensive empowerment package that also includes help with the organisation of production, obtaining credit and the marketing of the product.

A CLEAR PATTERN OF AN EMPOWERMENT PROCESS

Despite some differences between the responses of tribals and non-tribals, a reasonably clear pattern of the process of women's empowerment in rural India emerges. It is universally recognised that in south Asia, land titles are held mostly by men. Hence, for women's empowerment, customary rights are quite important. It appears that poor women in rural India still possess customary rights to collect forest produce although they are experiencing a decline in its supply. For their economic independence, it is important for them to undertake some income-earning activities. But it is difficult for them to engage in production activities, as the interest rate for a loan from the village moneylender is exceedingly high.

While some borrow from the bank, the major reasons for not borrowing from the bank for production activities are a lack of availability of small loans, a lack of assets for use as collateral and an inability to organise production without help from others. If these difficulties that prevented them from taking bank loans were removed, a majority would be willing to take loans at an interest rate of around 10 per cent. These women require the support of NGOs to obtain a low interest loan, to purchase inputs, to organise production and to sell their products. If women could develop group action, it could help them solve some of these problems noted above. Unfortunately they have not been able to do so because the development of such group action would require the joint efforts of women of several villages. But women of different villages may not easily join hands because of the 'ideology of seclusion', caste differences, difficulty in getting the permission from the head of the family, the absence of someone to take the leadership role, and lack of knowledge about the power of group action (social dynamics).

Hence the restriction on women's freedom of movement needs to be lifted. Implementing programmes of community education for elders and adult members of rural families would facilitate this process of lifting of gender restriction. However these women also need formal education and skills-based education along with community education in a comprehensive education scheme. They would like to participate in an empowerment process consisting of comprehensive education, help with the organisation of production and credit and marketing facilities. To implement such an empowerment package, women need a guided participatory system of development. In other words, women with the guidance of NGOs and help from the state can implement the programme. Women also need female extension agents for knowledge and technology transfer.

GLOBALISATION AND EMPOWERMENT: SOME PASSING REMARKS

Globalisation can produce the most enduring beneficial effect on women's empowerment if it can weaken the forces of the 'ideology of seclusion' embodying gender discrimination. Since the forces of the 'ideology of seclusion' exercise strong influence on the decisionmaking process in each institution that affects women's employment, these forces of gender discrimination must be weakened. However, social customs and traditions die hard, and cannot be as easily changed as the economic institutions. It has been found that greater industrialisation, trade and commerce and greater interaction with the outside world, weaken the forces of gender restriction. Thus women in Bombay and Delhi are less subjected to gender restriction in pursuing their activities and desires than women in Calcutta (Roy and Tisdell, 1996). Gender based restrictions on women are more severe in villages than in small rural towns, more severe in small rural towns than in district towns and more severe in district towns than in the metropolis (Roy and Tisdell, 1996).

Under globalisation, the vast rural hinterland of India is slowly being connected with the rest of the world. Globalisation is making women, even in villages, aware of the social and economic condition of women in advanced countries as well as in leading developing countries. Women in rural India can now learn through television how women in other countries are leading their lives, how much freedom they enjoy and how small the effect of derogatory social customs and traditions is on their lives. Through the Internet they can now communicate with women in other countries. This helps the formation and growth of transnational social dynamics.

As mentioned earlier, the community education of all adult members of the family and the community would make the elders aware of the futility of enforcing the gender restriction on women members in the family. It is only through this kind of education that the force of the 'ideology of seclusion' can be weakened. Globalisation through the spread of multi-channel television programmes and the Internet has provided, in a sense, the community education in India's rural hinterland. Adult members of the rural community can now watch television and get to know how adult family members treat younger women and girls in families and how the adult members of the community (a suburb) treat younger females in advanced Western countries. In early 1992 during fieldwork in a rural town in West Bengal, the present author found that young educated girls could not talk freely to young boys in their neighbourhoods, could not travel to other places at some distance from their homes to obtain higher education or in search of employment or even to attend social functions because of the

enforcement on them of the 'ideology of seclusion'. But India's interaction with the outside world began to increase with the opening up of the Indian economy in 1991. In 2001, the present author visited the same rural town and found that the forces of the 'ideology of seclusion' on young educated girls, although not completely eradicated, had been weakened.

The adoption of a group approach by women in exercising their rights can weaken the force of the 'ideology of seclusion'. This has been happening. A case in point is 'Nistha', a women's organisation formed in 1974 with the objective of empowering women. In 1995 when the Cairo Convention of the UN had worked out a blueprint for empowering women in third world countries 'Nistha' had become synonymous with 'female power'. Parul Mondal, a member, said that when they started 'Nistha', their husbands would beat them up and prevent them from attending its meetings. They used to rebuke them saying that women should stay at home and cook instead of attending meetings. They had to combat great odds in their fight to earn their just rights. Gouri Sardar said that her husband once threw a pot of boiling rice at her for attending a meeting and talking about 'female power'. Today he has been forced to accept that she too will work and earn her bread. A student, Aparna Mondal, said once her parents did not let her mix with boys, attend school or watch films. Today all the girls in her village go to school. The boys and her brothers are also supportive of her and also fight to make sure that girls are educated and earn their right to work. 'Nistha' now operates in 60 villages in South and 24 Parganas District in West Bengal (*The Times of India*, 2001). 'Nistha' provides girls' and women's development through non-formal learning, working to improve women's and adolescent health, including re-productive health, promotes self-sufficiency and the alleviation of poverty.

India's increasing outward orientation and openness to the West will facilitate the growth and strengthen the power of such organisations as 'Nistha' to fight for women's empowerment. Globalisation can thus weaken the forces of the 'ideology of seclusion', help develop group action and thereby facilitate the process of women's empowerment in India. Group action is producing results relating to rural women's empowerment. A women's group called 'Mahila Samakhya' endeavours to create a learning environment where women can collectively affirm their potential, gain the confidence to demand information, knowledge, and move forward to change their lives. The programme revolves around the 'Mahila Sangha' (the village level women's organisation).

Mahila Samakhya has expanded its coverage to 51 districts and about 7335 villages in the states of Uttar Pradesh, Karnataka, Gujarat, Andhra Pradesh, Bihar, Madhya Pradesh, Assam and Kerala. Such a mobilisation of women has resulted in a clear demand for education. These 'sanghas'

also play an important role in the social life of women in the villages. In Bihar, Karnataka and Andhra Pradesh, the 'sanghas' have virtually stopped child marriages. In Andhra Pradesh, they have stopped the institution of girls as 'Debdasis' (maids of gods and goddesses). In UP and Gujarat, 'nari adalats' (the women's courts) have emerged as effective informal courts where cases relating to domestic violence, land disputes, dowry, rape and so on are taken up. To meet the growing demand for economic and livelihood options; the 'sangha' has established links with commercial banks (*The Statesman Weekly*, 2001). With increasing globalisation of the Indian economy, such group action will continue to gain momentum.

CONCLUDING REMARKS

The improvement of women's economic condition is considered to be one of the most important objectives in development issues. Both the World Bank and the United Nations have taken an active interest and participation in various projects trying to improve the economic situation of women. However, institutional factors prevent women from improving their economic condition and achieving empowerment. It has been established that education is the most important prerequisite for uplifting the status of women in general and of poor rural women in particular. But due to the 'ideology of seclusion' many poor women do not get any education at all. The education that some of them receive is usually not appropriate for obtaining employment because they have not chosen that type of education but had it imposed upon them. Even when the education is appropriate, a woman may not be able to take up an appointment if an offer is made, due to the 'ideology of seclusion'. Therefore if education is to be of any use for rural women's empowerment, then measures need to be taken to weaken the forces of the 'ideology of seclusion'.

In the case of property rights, we have noted that women do not usually possess ownership rights to land. But even where women do possess ownership rights, they may not be able to exercise them owing to the absence of customary rights, which are governed by social customs. Therefore, in the case of property rights, the 'ideology of seclusion' creates hindrances to women exercising the right. Hence the removal of institutional difficulties standing in the way of women's empowerment would require the removal of customs and prejudices affecting women's empowerment. How can these be removed? This is where globalisation has a valuable role to play. We have commented on how globalisation can play a role to weaken the force of customs and prejudices (the 'ideology of seclusion'). In this chapter we have examined only the influence of social institutions on rural women's

empowerment. But economic institutions are also changing under the influence of globalisation. The discussion of that is beyond the scope of this study. It can therefore be said that a conducive institutional environment is the most fundamental prerequisite to women's empowerment and globalisation can facilitate the creation of such an environment.

NOTES

1. For a detailed discussion of the effect of social taboos on women's lives see: Roy et al. (1996) and Kandiyoti (1985).
2. Agarwal (1989); Bhalla (1989); Chen (1989); Duvvury (1989); Jodha (1986); Roy and Tisdell (1993a, b); Roy and Clark (1994); Roy et al. (1992, 1995); Roy and Tisdell (1996).
3. This section has drawn on the following work of the author: Roy and Tisdell (2000).
4. Obtained through private conversation with students and parents during the field survey.
5. The section has drawn on the following work of the author: Roy and Tisdell (2001).
6. Revealed through personal interviews with women and men in Kandh tribes in Fullbari district in Orissa in January 2000.
7. Revealed through personal interviews with women in Kandh tribes in Fullbari district in Orissa in January 2000.
8. Fieldwork, January 2000.
9. Fieldwork in Pirakata and Groaltore areas in Midnapore District in West Bengal, January 2000.
10. Fieldwork among Kandh tribes in Fullbari District in Orissa and among Santals in Groaltore and Pirakata regions in Midnapore District in West Bengal, January 2000.

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12. Estate taxes and family-run firms: an empirical study of publicly traded corporations in China, Hong Kong and Taiwan*

Kam-Ming Wan, Shi-Jun Liu and Hsihui Chang

INTRODUCTION

This chapter examines the effect of costs of wealth conservation across generations and government policy regarding ownership concentration on the prevalence of family-run firms in China, Hong Kong and Taiwan. If individual investors are not restricted from controlling any publicly held corporations, we argue that higher costs of wealth preservation across generations, particularly inheritance taxes, lower the formation of family-run firms. Our empirical results support this claim. We find that family-run firms are the least common in China among these regions because the Chinese government disallows individual investors from holding concentrated ownership in any publicly traded firms. We also find that family-run firms are most common in Hong Kong because of its low tax rate on estates and the ease with which inheritance taxes can be avoided. To the best of our knowledge, this chapter is the first to examine and document the significance of family-run firms in these regions.

Current research has underscored the importance of the family firm as an economic organization around the world.[1] For example, La Porta, Lopez-De-Silanes and Shleifer (hereafter LLS, 1999) examine the stock ownership of the 20 largest publicly traded companies around the major stock markets. They find that about 30 per cent of their sample firms are family firms. Bhattacharya and Ravikumar (2001) find that family firms account for 40 per cent of US Gross Domestic Product (GDP) and 66 per cent of Germany's GDP. Family firms are even more common in east Asian countries than in Western countries. Claessens, Djanvo and Lang (hereafter CDL, 2000) investigate the stock ownership of the nine

east Asian countries. They show that seven of the nine east Asian countries have above 50 per cent of their publicly traded companies as family firms.

Despite the significance of the family firm as an economic organisation in the world economy, many issues regarding family firms are still unresolved. For example, why are family firms more prevalent in the east Asian countries than in the Western countries? Do family firms perform better than firms run by professional managers? Could institutional differences explain the relative importance of family firms in these economies? Since we believe in the importance of institutions in shaping the formation of family-run firms, in this chapter, we examine the effect of institutional differences regarding taxes on estates and gifts on the pervasiveness of family-run firms in China, Hong Kong and Taiwan. We choose these regions because they have a similar ethnic background and yet different laws and institutions regarding wealth transfer across generations.

Using data on 1704 publicly traded corporations in these regions in 2000, we find that the costs of preserving individual wealth, in particular laws regarding inheritance and gift taxes, affect the pervasiveness of family-run firms in these regions. In addition, government regulation regarding ownership concentration within an individual is also important to the formation of family-run firms. We find that family-run firms are most common in Hong Kong and least common in China. The low estate and gift tax rates together with the ease with which taxes can be avoided in Hong Kong facilitate wealth preservation across generations and the formation of family-run businesses. Although inheritance and gift taxes are literally absent in China, the socialist planning economy has long discouraged wealth creation, let alone wealth preservation. Besides, we find the under-representation of family-run firms in the cohort of larger enterprises in the Chinese economy, especially for publicly held corporations due to the government preference for State Owned Enterprises (SOEs).

We discuss the history and institutional differences among these regions in the next section. The third section describes the tax systems regarding estates and gifts in these regions. In the fourth section, we attempt to link the prevalence of family-run firms with the costs of wealth conservation and laws regarding ownership concentration. We discuss the data and variables used in the fifth and sixth sections. In the seventh section, we provide examples of family-run firms in these regions. The empirical results are detailed in the eighth section and the ninth section concludes.

HISTORY AND INSTITUTIONAL DIFFERENCES AMONG CHINA, HONG KONG AND TAIWAN

Given the geographic closeness and common ethnic background, it is not surprising to see the similarity in languages, religions and cultures in China, Hong Kong and Taiwan. However, the last 150 years of history render these three regions distinct economic and political entities. Following its defeat in the First Opium War, China ceded Hong Kong island to Britain in perpetuity in the Treaty of Nanjing in 1842. From later British victories over China, Britain gained Kowloon in perpetuity in 1860 and acquired the New Territories in 1898 for a 99-year lease.[2] Britain returned Hong Kong (including Hong Kong island, Kowloon, and the New Territories) back to China in 1997. Currently, Hong Kong is under the sovereignty of the People's Republic of China and the Chinese government guaranteed that Hong Kong would have the same lifestyle and market system for 50 years following the handover.

The relationship between Taiwan and China has witnessed periods of integration and separation. Originally, Taiwan was settled by people of Malay– Polynesian descent. Between 1624 and 1662, Taiwan was occupied by the Dutch. In 1662, the Dutch were defeated by Cheng-gong Zheng, a loyalist of the Ming dynasty of mainland China. In 1683, Ching troops defeated Zheng's successor. It wasn't until 1887 that the Manchu Imperial authority declared Taiwan as a 'province' of mainland China. However, in 1895, the Japanese defeated the Manchus in the Sino-Japanese War and China ceded Taiwan to Japan in perpetuity. The Japanese occupied Taiwan from 1895 to 1945 and returned Taiwan back to China in 1945 when they lost the Second World War. The Nationalists were the ruling party in China during that time. In 1949, the Nationalist Party lost the war in mainland China to the Communist Party and fled to Taiwan. The Communist Party has since ruled China while the Nationalist Party ruled Taiwan from 1949 and ended its control in 2000 when it lost the presidential election to the Democratic Progressive Party.

The historical ties among these regions bring striking similarity in their background (Table 12.1 compares ethnic composition, languages, religions, legal origin, ranking of stock exchange, and per capita GDP in China, Hong Kong and Taiwan). The ethnic composition of these regions is homogeneous with over 90 per cent of their populations having Chinese descent. Their main religions are Buddhism and Taoism. The official language in these regions is Chinese (Mandarin Chinese in China and Taiwan and Cantonese Chinese in Hong Kong) with the exception of Hong Kong, where English is also an official language.[3]

The different historical backgrounds affect the types of legal system these regions adopt. As a British colony, Hong Kong naturally adopted

Table 12.1 Country profiles

	China	Hong Kong	Taiwan
Ethnic composition	Predominantly Chinese descent (91.9%)	Predominantly Chinese descent (95%)	Predominantly Chinese descent (98%)
Languages	Mandarin Chinese	Cantonese Chinese and English; both are official	Mandarin Chinese
Religions	Buddhists and Taoists make up the vast majority; officially atheist	Buddhists and Taoists make up the vast majority	Mixture of Buddhist, Confucian and Taoist (93%)
Legal system	A complex amalgam of custom and statute, largely criminal law; rudimentary civil code in effect since 1 January, 1987	English common law	Civil law
Ranking of the stock exchange in the world (1999)[a]	12 or 13[b]	11	17
GDP per capita (2000)	US$856[c]	US$24 049	US$14 019[d]

Notes:
[a] Source: *Ranking of the World Stock Markets* (2000).
[b] According to the Securities and Futures Commission of Hong Kong, the combined market capitalisation of China's stock exchanges (SHSE and SZSE) was US$581 billion by the end of 2000. We believe that combined China's stock market should have been ranked the 12th or 13th largest stock exchange in the world during 1999. The 11th and 12th largest stock exchanges are the Hong Kong Stock Exchange and the Luxembourg Stock Exchange, respectively. Their respective market capitalisation was US $608 355 million and US $556 888 million at the last trading date in 1999.
[c] Source: World Development Indicators database, World Bank.
[d] Source: *The Republics of China at a Glance – Taiwan 2001*.

Sources: *Hong Kong Yearbook* (2000), *Moody's Financial Information Services* (2002), *Language, Society and Ethnic Identity* (1993), and *Religions in the Republic of China* (1993).

English common law as its legal system. The legal system in Taiwan is based on civil law emphasising the statutory legal structure rather than common law. The legal system in China is more complicated because China was never under the sovereignty of any European country. The current legal system in China follows a mix of local custom and statute mainly in terms of criminal law.

Under the sovereignty of the British government, Hong Kong has developed a stable political system, a well-established legal system, and a low-tax environment. These conditions encourage the formation and preservation of wealth. Although Hong Kong was a relatively unknown shipping port a century ago, it is now an important financial centre in the world market. The per capita GDP in Hong Kong was US $24 049 in the year 2000, ranked 17th in the world, compared to US $33 934 in the USA, which is ranked 5th in the world. The Hong Kong Stock Exchange (HKSE) was the 11th largest stock exchange in the world in 1999; its market capitalisation was half the size of the largest stock exchange in the world, the New York Stock Exchange (NYSE).

Wealth creation and economic performance have also been spectacular in Taiwan since the Taiwanese government implemented various firm policies towards economic growth in late 1970s. The per capita GDP in Taiwan was US $14 019 in 2000, which is ranked 25th in the world. The Taiwan Stock Exchange (TSE) ranked 17th in the world in 1999 and its total market capitalisation was about one-quarter of the total market capitalisation of the NYSE.

Unstable political and economic regimes have long hindered wealth creation in China. It was not until Deng Xiaoping's open door policy in 1978 that the economy started to blossom. Despite the significant economic growth in China for the past two decades, China's performance and wealth creation is still lagging behind many developed countries. The per capita GDP in China was only US $856 in 2000, ranked 78th in the world. In 1999, the combined market capitalisation value of the two stock exchanges in China (Shanghai Securities Exchange (SHSE) and Shenzhen Securities Exchange (SZSE)) would have been ranked the 13th largest stock market in the world in 1999.

Since the listing requirements in China are quite different from other developed stock markets, for the sake of clarity we provide some basic information about China's stock market. The stock market in China has been growing rapidly for the last decade. In 1994, the ratio of stock market capitalisation to GDP in China was only 8 per cent, rising to about 50 per cent in 2001. There were only 291 publicly held firms in China by the end of 1994 but this increased to more than one thousand by the end of 2001. Most of the corporations listed on China's stock exchanges are state-owned

because the Chinese government determines which corporations are eligible for listing on China's stock exchanges.[4] The Chinese government heavily favours the listing of SOEs, reasoning that public ownership of the SOEs can divest the state assets and revive the SOEs.[5] The preference for listing the SOEs seems to be weakening following the recent growth in information technology. Since China is moving towards a market economy and the private sector is gaining importance over time (in 1978, 78 per cent of the total industrial production came from SOEs: that figure diminished to 33 per cent in 2000), we expect that more corporations from the private sector will list their shares in China's stock exchanges once the Chinese government reduces its control over economic activities after its entry into the World Trade Organization.

THE TAX SYSTEM REGARDING ESTATES AND GIFTS IN CHINA, HONG KONG AND TAIWAN

The costs of wealth preservation across generations have been low in Hong Kong. The inheritance tax was introduced in Hong Kong in the late 1900s and has been low compared to many countries. Since 1 April 1998, the inheritance tax has been exempt on estates valued below HK $7.5 million (US $0.962 million). The marginal tax rate on inheritance starts at 5 per cent for estates above HK $7.5 million and rises up to a maximum of 15 per cent for estates above HK $10.5 million (US $1.346 million). This is small in comparison to other countries. For example, in the USA, the top marginal tax rate of inheritance is 55 per cent. While inheritance tax in Hong Kong is also lower than in Taiwan, it is higher than in China. Table 12.2 compares the inheritance tax schedule among China, Hong Kong, Taiwan and the USA.

In addition, laws in Hong Kong permit donors to avoid estate duty with good planning. *Inter vivos* gifts are exempt from estate duty if the gifts are made more than three years prior to the death of the donors. For example, if Mrs A. gives 500 shares of company XYZ to her son in 1990 and passes away in 1995, her gift is exempt for the purpose of estate duty.[6] Although estate taxes can be avoided by *inter vivos* gifts, the donors will lose the control right of their assets immediately after giving. If Mrs A. wants to maintain the control right of her shares and avoid paying the estate duty, she can establish an offshore trust fund to hold her assets. By electing herself, the settlor, as the trustee of the assets for the benefit of her son, she maintains the control right of her assets until she dies. Setting up offshore trust funds in Bermuda and/or the Cayman Islands is commonly used to avoid paying estate tax in Hong Kong because inheritance taxes are exempt

Table 12.2 Estate tax schedules in China, Hong Kong, Taiwan and the USA

Gross principal value of the estate (US$)		Estate tax rate (%)			
		China	Taiwan[a]	Hong Kong	USA
Exceeds	*Does not exceed*				
0	199 430	0	0	0	0
199 430	675 000	0	2–20	0	0
675 000	961 538	0	20–26	0	18–34
961 538	1 153 846	0	26	5	34
1 153 846	1 346 154	0	26	10	34–37
1 346 154	3 675 000	0	26–41	15	37–53
3 675 000	5 344 729	0	41	15	55
5 344 729	–	0	50	15	55

Note: [a] An exemption of NT $7 000 000 (US $199 430) is allowed for each decedent. Our computation relies on the assumption that the decedent has only one heir for whom he takes the maximum exemption.

for any asset deposited in trust funds in these countries. Many Hong Kong tycoons such as Lee Shau-kee, the late Pao Yue-kong, and Michael Kadoorie have established similar offshore trust funds to hold their personal assets, particularly shares of their companies, to avoid paying estate taxes to the Hong Kong government. Besides, companies' assets are also exempt from inheritance taxes so long as the companies are incorporated in those countries.

In Taiwan, the tax system penalises wealth conservation as heavily as in the USA and increases the costs of wealth preservation across generations. Estate duty in Taiwan can be as high as in the USA. The top marginal tax rate on inheritance is 50 per cent for estates slightly above NT $100 million (US $2.9 million), five percentage points less than the top rate on inheritance in the USA. However, tax exemption for inheritance is smaller in Taiwan than in the USA. In Taiwan, inheritance tax is exempt for estates valued below NT $7 million (US $199 420), compared to US $675 000 in the USA. In addition, donors cannot avoid estate duty by making gifts because gifts are taxable in Taiwan as well. The annual tax exemption for gifts is NT $1 million (US $28 490) and the top marginal tax rate is also 50 per cent for gifts above NT $45 million (US $1.31 million).[7] While middle-income donors can reduce their estate duties by spreading out their gifts throughout their lives, the tax advantage of this strategy is deemed to be minimal for wealthy individuals.

In principle, wealthy individuals can avoid paying estate taxes if they incorporate their businesses in a country that levies no inheritance tax. However, this tax avoidance method is costly in Taiwan as well because the Taiwan Securities and Exchange Commission (TSEC) disallows any companies to be listed on the TSE when they incorporate outside Taiwan. Thus, incorporating outside Taiwan denies a company access to capital in Taiwan, thereby increasing its costs of capital. Second, the Taiwanese government imposes an ownership requirement on foreign capital. Any foreign capital, for example, assets in offshore trust accounts and companies could only be used to control not more than 50 per cent ownership of any publicly held corporations in Taiwan. Despite the aforementioned restrictions, many wealthy individuals in Taiwan take advantage of the loopholes in their domestic tax system to reduce their estate taxes. For example, they can reduce their inheritance tax liability when they pass on their wealth to a nominal investment company. Inheritance taxes are only levied for legal capital, usually the initial capital, in a nominal investment company. In addition, the owner of the nominal investment has no obligation to disclose the market value of the legal capital; any capital appreciation from the legal capital is thus exempt for inheritance tax purposes.

In addition, wealthy individuals can establish domestic charitable trusts and even private foundations to avoid inheritance taxes. Under Taiwanese law, income and estate duties are waived for any donations to non-profit organisations or charitable trusts. Individuals maintain indirect control of their personal assets by donating such assets to a charitable trust and electing themselves and their family members as trustees to oversee its management.[8] Although these methods do not transfer wealth directly to the donors' relatives, they allow the donors' family to retain control and investment rights over the wealth in the foundations and trusts.

The costs of wealth preservation across generations in China are the lowest in the region owing to the absence of inheritance and gift taxes. Except for a brief 10-year period, taxes on inheritances and gifts have been largely absent in Chinese history (see Li, 1991). However, the costs of wealth conservation are a relevant consideration only when individuals have wealth to distribute across generations. The socialist planning economy that promoted income equality in China limited wealth creation until the open door policy in 1978. Thus, conservation of wealth across generations has not been a major concern to individuals until recently. Currently, the Chinese government proposes to levy taxes on inheritance. The taxes will be levied on inheritances worth a minimum of CNY $1 million (US $120 773), and the maximum tax rate will be kept at around 50 per cent. The inheritance taxes, if implemented, will affect the richest 1–3 per cent of the mainland Chinese population.

INHERITANCE TAXES AND FAMILY-RUN FIRMS

We expect that higher costs of wealth conservation across generations will reduce a donor's incentive to bequeath wealth and increase her incentive to consume. For example, if a parent wants to make a bequest of $100 and faces a marginal estate tax rate of 55 per cent, the estate will pay a tax of $55 and the heirs receive only $45. In this case, even if the donor consumes the $100 herself and leaves no bequest to her heirs, the marginal cost of spending that $100 is only $45 and not $100. It is because by not spending that $100 herself, the government will tax her estate for $55, leaving her heirs with only $45. We expect that the higher the marginal tax rate on inheritance, the lower the bequest motive for a donor.

Like most developed countries, wealthy individuals in Hong Kong and Taiwan have most of their wealth on paper, in the form of firm equity rather than cash. This is particularly true for entrepreneurs or businesspeople. Facing a lower tax rate on inheritance, companies' founders have a stronger incentive to pass on their company's ownership and control to their relatives. Thus, we expect to observe a larger proportion of family-run firms when the costs of wealth conservation are smaller and most of the donor's wealth is in company equity.

Owing to the lower tax rate on inheritance and ease with which estate taxes can be avoided in Hong Kong, we argue that wealth preservation is less costly in Hong Kong than in Taiwan. Thus, we expect that the bequest motive will be stronger in Hong Kong than in Taiwan, *ceteris paribus*. The well-established stock markets in these regions allow individuals to accumulate wealth in the form of company equity and the formation of family-run businesses. We predict the proportion of publicly traded family-run businesses to be more prevalent in Hong Kong than in Taiwan.

Due to the absence of inheritance tax in China, we expect that the costs of wealth preservation across generations are the smallest in China among the three regions. While we predict that family-run firms should be more common in China than the other two regions, we argue that *publicly held* family-run firms in China should be the least common. This is because the Chinese government prohibits individuals and limits wealth conservation through company equity across generations. Tian (2000) finds that the Chinese government permits any domestic individual investors to hold at most 0.5 per cent of any companies listed in China's stock exchanges. In addition, the historically poor economic performance in China has left very little wealth to the current generation, let alone to conserve across generations. Thus, inheritance taxes are less relevant for the new riches in China relative to those riches in Taiwan and Hong Kong.

According to our previous analysis on the pervasiveness of family-run firms, we have the following testable hypothesis: *If individual investors are alllowed to hold concentrated ownership of any publicly traded corporations, we expect that family-run firms are more widespread in regions with lower costs of preserving family wealth than in regions with higher costs,* ceteris paribus.

SAMPLE AND DATA

Our sample is comprised of 1704 publicly traded corporations from the Shanghai Securities Exchange (SHSE), the Shenzhen Securities Exchange (SZSE), the Hong Kong Stock Exchange (HKSE) and the Taiwan Stock Exchange (TSE). We identified 756 firms on the HKSE using Datastream, 587 firms on the TSE using the *Taiwan Economic Journal* (TEJ) data bank and 754 firms on the SHSE and the SZSE using Datastream. We exclude 50 Chinese companies that are cross-listed on the HKSE (known as H shares) to avoid duplication.[9] We further exclude 271 Hong Kong firms and 72 Taiwanese firms with missing data on ownership and market capitalisation. The final sample contains 754 Chinese firms, 435 Hong Kong firms and 515 Taiwanese firms.

We obtain immediate ownership data in the year 2000 from Shareworld for corporations listed on the HKSE, an official web-site (www.cninfo.com.cn) mandated by the China Securities Regulatory Commission for corporations listed on the SHSE and the SZSE, and the TEJ data bank for companies listed on the TSE.[10] Since the types of ownership have different implications on inheritance taxes and ultimate ownership can be quite different from immediate ownership for corporations listed in these exchanges, we attempt to identify the ultimate ownership for our sample firms. For example, many corporations listed on the HKSE and the TSE are controlled through a pyramid structure (a firm controlling other firms through at least one publicly listed company) or cross-holdings (where both companies hold shares of each other's companies). We obtain data on ultimate ownership from various annual reports closest to the year 2000 for corporations listed on the HKSE. Companies listed on the HKSE usually disclose their family ties among members of the board of directors and senior managers. We searched the company's web-site and other sources to identify family relationships if data on family ties are missing in their annual reports but we suspect the company to be family-run. Unfortunately, data on ultimate ownership is not available in annual reports for corporations listed on the two Chinese stock exchanges and the TSE. We are confident that

family-run firms are absent for publicly held corporations in the Chinese stock exchanges due to the various government regulations. Because of this, we assumed that the immediate shareholder is the same as the ultimate shareholder. For corporations listed on the TSE, we rely on our sources and conduct telephone interviews to establish the ultimate ownership of these firms.[11]

We collect data on market capitalisation from Datastream. We also obtain data on years of incorporation from Lexis-Nexis for companies listed on the HKSE and in the TEJ data bank for companies listed on the TSE. Missing data on years of incorporation have been supplemented from the *1993 Asian Company Handbook*.

DEFINITION OF VARIABLES

Unlike LLS (1999), we divide individual and family-run firms into two distinct types of firms reasoning that they have quite different economic behaviour and performance. Wan (2001) finds that while it is common for CEOs in family-run firms to keep managing their firms beyond the normal retirement age, such privilege is rarely observed for CEOs in non-family-run firms. In other words, controlling shareholders in family-run firms could consume private benefits and lower their firms' performance. In our opinion, Microsoft is more like an individual but professionally managed firm and the *Washington Post* is more like a family-run business (controlled and run by the Graham family): however, both firms are classified as family firms according to the ownership requirements in LLS (1999).

To separate family-run firms from individual firms, we define a firm as family-run according to two criteria: dominance of control rights and family succession for key executive positions. We argue that a family group has the dominant control if it is the largest shareholder of the company and controls 10 per cent (or 20 per cent according to the cutoff for control) of the company shares. This criterion makes sure the family group has amassed enough voting power to elect its family members to run the company. We also expect that, in a family-run firm, a family group has the intention of continuing to manage the firm. Thus, succession for the key executive officer is from within rather than outside the family group. We further require that at least one person who is related to the controlling shareholder by blood holds a key executive position such as executive director, managing director, chairperson or vice-chairperson in the firm. The current empirical facts provide support for the family succession requirement. It is well known that it takes years to groom a successor

for the CEO position. It is not surprising to see that aspiring CEO successors work for the company for a long period of time and hold key executive positions prior to their appointment to the CEO position. Vancil (1987) finds that CEO successors are typically chosen several years prior to the CEO's departure and are groomed for the top position over a period of time. Smith and Amoako-Adu (1999) find that the majority of CEO successors in family businesses are appointed as either vice-president or chief operating officer prior to their promotions to CEO or president.

We define a firm as family-run at the 10 per cent (20 per cent) level for control if the largest shareholder controls 10 per cent (20 per cent) of the company shares and a person related to the largest shareholder by family ties also holds a key executive position as executive director in the company. We define a firm as widely held at the 10 per cent (20 per cent) level for control if the largest shareholder controls less than 10 per cent (20 per cent) of the company shares. For non-family and non-widely held corporations, we divide the sample into five categories: individual, widely held financial, widely held corporation, state, and miscellaneous corporation. A firm is defined as an individual firm if the largest shareholder is an individual. We define a firm as widely held financial (widely held corporation) if the largest shareholder is a financial institution (corporation and non-financial institution) such as a bank, investment company, insurance company, finance company, etc. We define a firm as a state firm if the largest shareholder is the central government. For the rest of the sample firms, we classify them as miscellaneous. Table 12.3 contains detailed descriptions of each variable.

We also classify the types of family ties within a family-run firm. We define a family-run firm as parent–child related if either a parent or child of the controlling shareholder holds a director position in the corporation. We classify a family-run firm as sibling (spouse) related if either the brother or sister (husband or wife) of the controlling shareholder holds a director position in the corporation. We define a family-run firm as distant relative related if a person related to the controlling shareholder by family ties (except for parent–child, sibling, or spouse relationship) holds a director position in the corporation. We classify a family-run firm as multiple related if there is more than one type of family relationship in the corporation. We measure firm size (FirmSize) by the market capitalisation on the last trading day in 2000 and firm age (FirmAge) by years of incorporation through the year 2001.

Table 12.3 Definition of variables

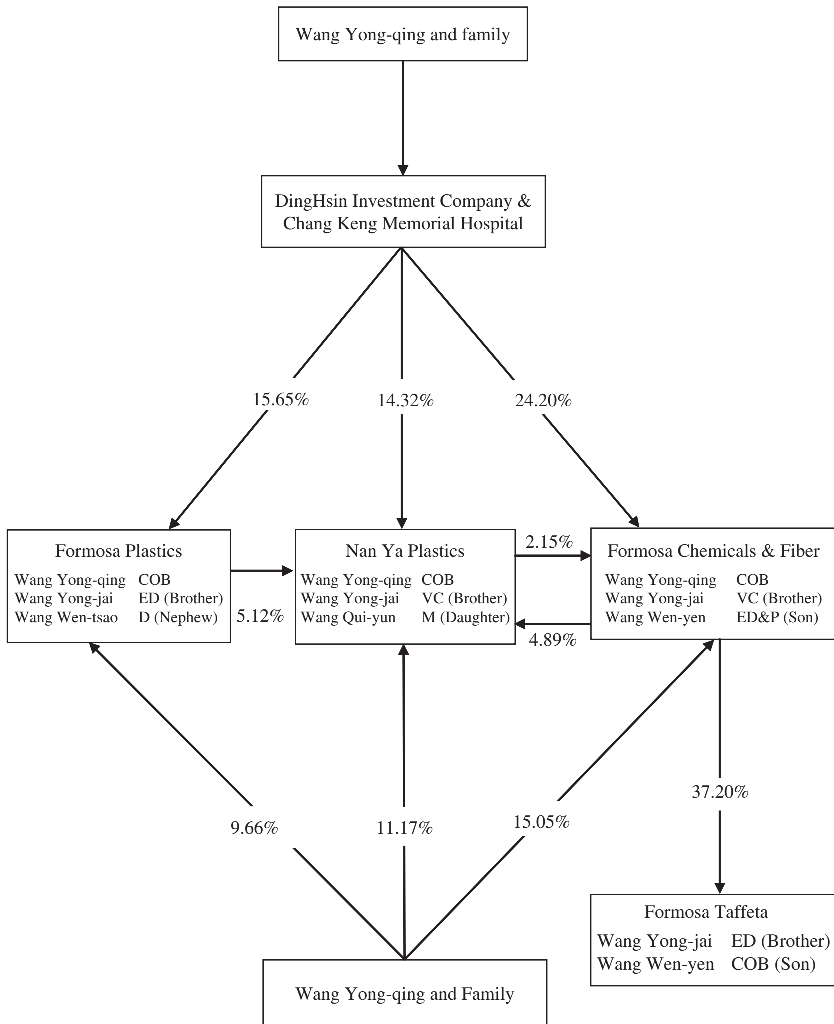
Variable	Definition
Family-run firm	Equals one at the 10% (20%) cutoff for control if a person or a family group is the largest shareholder of the firm and controls 10% (20%) of the company shares. Besides, at least a person related to the largest shareholder by family ties holds a key executive position as chairperson, vice chairperson, executive director, managing director, president, or senior manager in the company; zero otherwise.
Widely held firm	Equals one at the 10% (20%) cutoff for control if the largest shareholder controls less than 10% (20%) of the company shares; zero otherwise.
Widely held financial	Equals one at the 10% (20%) cutoff for control if the largest shareholder is a financial institution such as an investment bank, investment advisor, mutual fund, or an insurance company and controls 10% (20%) of the company shares; zero otherwise.
Widely held corporation	Equals one at the 10% (20%) cutoff for control if the largest shareholder is a corporation (non-financial institution) and controls 10% (20%) of the company shares; zero otherwise.
Individual firm	Equals one at the 10% (20%) cutoff for control if the largest shareholder is an individual entity (neither a corporation nor a non-financial institution) and controls 10% (20%) of the company shares; zero otherwise.
State firm	Equals one at the 10% (20%) cutoff for control if the largest shareholder is the central government and controls 10% (20%) of the company shares; zero otherwise.
Miscellaneous firm	Equals one at the 10% (20%) cutoff for control if the largest shareholder is a non-profit organisation such as a university or a charitable organisation and controls 10% (20%) of the company shares; zero otherwise.
Parent–child	Equals one if a firm is classified as family-run and any members of the board of directors is related to the controlling shareholder as a parent or a child. For example, if the chairperson of the board is the

Table 12.3 (continued)

Variable	Definition
	controlling shareholder of the company and the CEO is a son of the controlling shareholder, we classify this firm as parent–child related; zero otherwise.
Sibling	Equals one if a firm is classified as family-run and any members of the board of directors is related to the controlling shareholder by family ties, as brothers or sisters; zero otherwise.
Spouse	Equals one if a firm is classified as family-run and any members of the board of directors is related to the controlling shareholder by marriage; zero otherwise.
Distant relative	Equals one if a firm is classified as family-run and any members of the board of directors is related to the controlling shareholder by family ties, as son-in-law, daughter-in-law, cousin, father-in-law or other distant relative; zero otherwise.
Multiple	Equals one if a firm is classified as family-run and any members of the board of directors is related to the controlling shareholder by more than one type of family relationship: for example, if the controlling shareholder of the company is the father and father-in-law of the company's CEO and the company's non-executive director, respectively. This family-run firm is classified as multiple related; zero otherwise.
FirmSize	Market capitalisation as of the last trading day of 2000.
FirmAge	Firm's years of incorporation through the year 2001.

EXAMPLES OF FAMILY-RUN FIRMS

The first example is the Formosa group, the largest family group in Taiwan (Figure 12.1). The Formosa group was founded by Wang Yong-qing in 1954 and comprises four corporations listed on the TSE: Nan Ya Plastics, Formosa Plastics, Formosa Chemicals & Fiber, and Formosa Taffeta. In terms of market capitalisation, they are ranked the 7th, 8th, 17th, and



COB = Chairperson of the Board; MD = Managing Director; ED = Executive Director; M = General Manager; VC = Vice-Chairperson of the Board; P = President; D = Non-executive Director.

Note: This figure describes the control structure of the Formosa group. Wang Yong-qing and family have ultimate control of the Formosa group. The Wang family's control of each group company is indicated by the percentage in the solid line. The titles of Wang Yong-qing and his family members in each group company are provided inside the box. Family ties with Wang Yong-qing appear in parentheses.

Figure 12.1 Control of the Formosa group (Taiwan)

88th largest publicly held corporations in Taiwan, respectively. The Wang Yong-qing family has ultimate control of the Formosa group through direct family holdings and indirect holdings such as a nominal investment company, a charitable organisation, and cross-holdings.

For example, the Wang family has 25.31 per cent control of Formosa Plastics. The Wang family's control of Formosa Plastics includes 9.66 per cent direct control through holdings by Wang Yong-qing and his family members. The Wang family's control of Formosa Plastics also includes 15.65 per cent indirect control through Chang Keng Memorial Hospital (a charitable organisation) and DingHsin Investment Company (a nominal investment company), which are indirectly controlled by the Wang family. The Wang family has direct control of the Chang Keng Memorial Hospital because Wang Yong-qing is chairperson of the board in the hospital, which gives him power to elect members of the board of directors.

Through direct and indirect holdings, and a pyramid structure, the Wang family has 35.5 per cent control of Nan Ya Plastics. The Wang family controls 11.17 per cent (14.32 per cent) of Nan Ya Plastics directly through individual holdings (indirectly through Chang Keng Memorial Hospital and DingHsin investment company). The Wang family also has 10.01 per cent control of Nan Ya Plastics indirectly through a pyramid structure. The Wang family has ultimate control of Formosa Plastics and Formosa Chemicals & Fiber, and these two publicly held companies in turn control 5.12 per cent and 4.89 per cent ownership interest, respectively, in Nan Ya Plastics. Similarly, the Wang family controls 37.2 per cent of Formosa Taffeta's shares in a pyramid structure indirectly through the Wang's family control of Formosa Chemicals & Fiber, a publicly listed corporation.

Cross-holdings are common for publicly held corporations in Taiwan as a method of increasing family control of other companies. For example, the Wang family has 4.89 per cent indirect control of Nan Ya Plastics and 2.15 per cent indirect control of Formosa Chemicals & Fiber by cross-holdings. Formosa Chemicals & Fiber controls 4.89 per cent of Formosa Plastics and the latter company also has 2.15 per cent control of the former company. Since the ultimate control of these two companies is the Wang family, the Wang family controls these companies' interests indirectly through cross-holdings.

We classify all companies in the Formosa group as family-run firms because the Wang family has at least 20 per cent control in each company of the Formosa group. Besides, the four companies are clearly managed by Wang Ying-qing and his family members. At over 85 years of age, Wang Yong-qing still chairs three companies of the group, and he has designated the successor for his position.

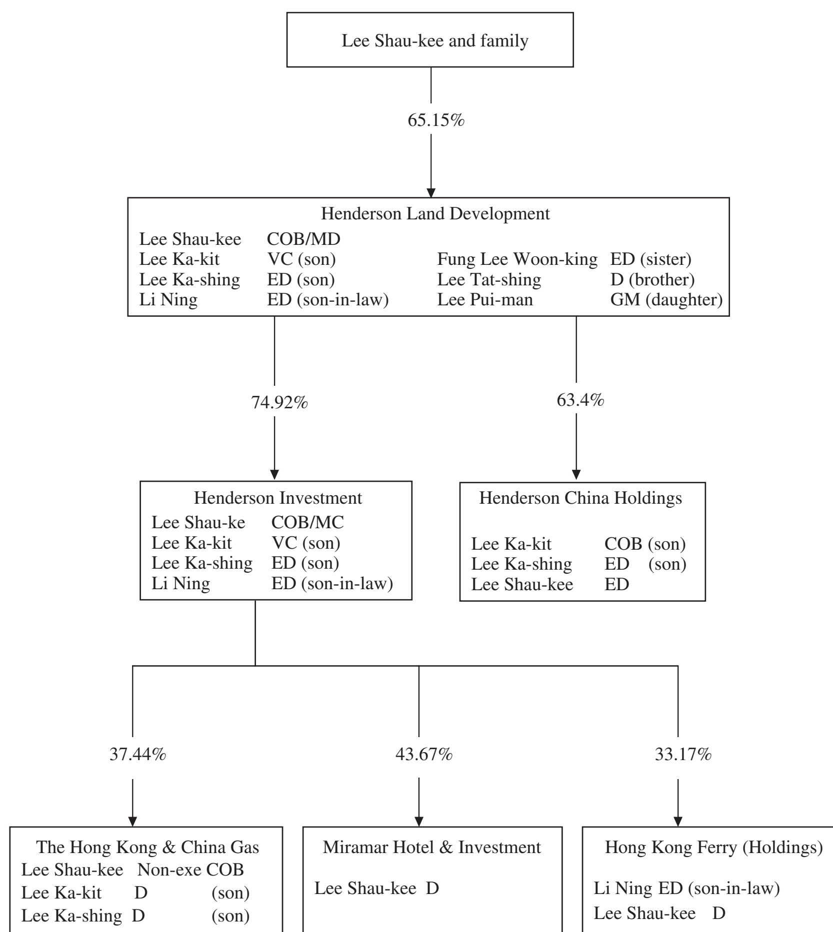
More specifically, one key successor for Wang Yong-qing is his brother (Wang Yong-jai), who holds a key executive position in every company of the Formosa group. Currently, Wang Yong-jai is the vice-chairperson in Nan Ya Plastics and Formosa Chemicals & Fiber. He also holds an executive director position in Formosa Plastics and Formosa Taffeta. The next in line for family succession are Wang Yong-qing's children. He has also appointed his son (Wang Wen-yen) as the chairperson in Formosa Taffeta and his daughter (Wang Qui-yun) as a general manager of Nan Ya Plastics. Close-knit relationships in the Formosa group can also be illustrated by Wang Yong-qing's appointment of his nephew (Wang Went-sao) as a director in Formosa Plastics.

We classify the type of family ties in Formosa Chemicals & Fiber as sibling related because the only family tie is between Wang Yong-jai, vice-chairperson of the firm, and his brother Wang Yong-qing, the chairperson and the controlling shareholder of the firm. We classify the other three companies in the Formosa group as multiple related because more than one type of family relationship occurs in these firms. For example, in Nan Ya Plastics, Wang Yong-qing is related to Wang Yong-jai as brother and related to Wang Qui-yun as father. Thus, Wang Yong-qing has two direct family ties (sibling related and parent–child related) in Nan Ya Plastics.

The second example is the Henderson group, the second largest family group in Hong Kong (Figure 12.2). The Henderson group was founded by Lee Shau-kee and comprises 6 corporations listed on the HKSE: Henderson Land Development, Hong Kong & China Gas, Henderson Investment, Miramar Hotel & Investment, Hong Kong Ferry, and Henderson China Holdings. In terms of market capitalisation, they are ranked as the 10th, 14th, 32nd, 79th, 100th, and 127th largest companies in Hong Kong, respectively. The Lee Shau-kee family has ultimate control of the Henderson group.[12]

Lee Shau-kee controls the Henderson group through Henderson Land Development of which his family has 65.15 per cent control through a discretionary trust fund registered in the Cayman Islands. The Lee family can avoid paying the estate taxes because inheritance is exempt for taxation purposes in the Cayman Islands.

Even with limited capital, a family group can control other publicly held companies through a pyramid structure. A pyramid structure refers to a family group that owns a majority control in a corporation and this corporation, in turn, owns a majority control in another publicly held company. The pyramid structure is commonly used by publicly held corporations in Hong Kong, for instance, the Cheung Kong group is controlled by the Li Ka-shing family and the Sun Hung Kai group is controlled by the Kwok family. In the case of the Henderson group, the Lee Shau-kee



COB = Chairperson of the board; MD = Managing Director; ED = Executive Director; GM = General Manager; VC = Vice-Chairperson of the Board; P = President; D = Non-executive Director.

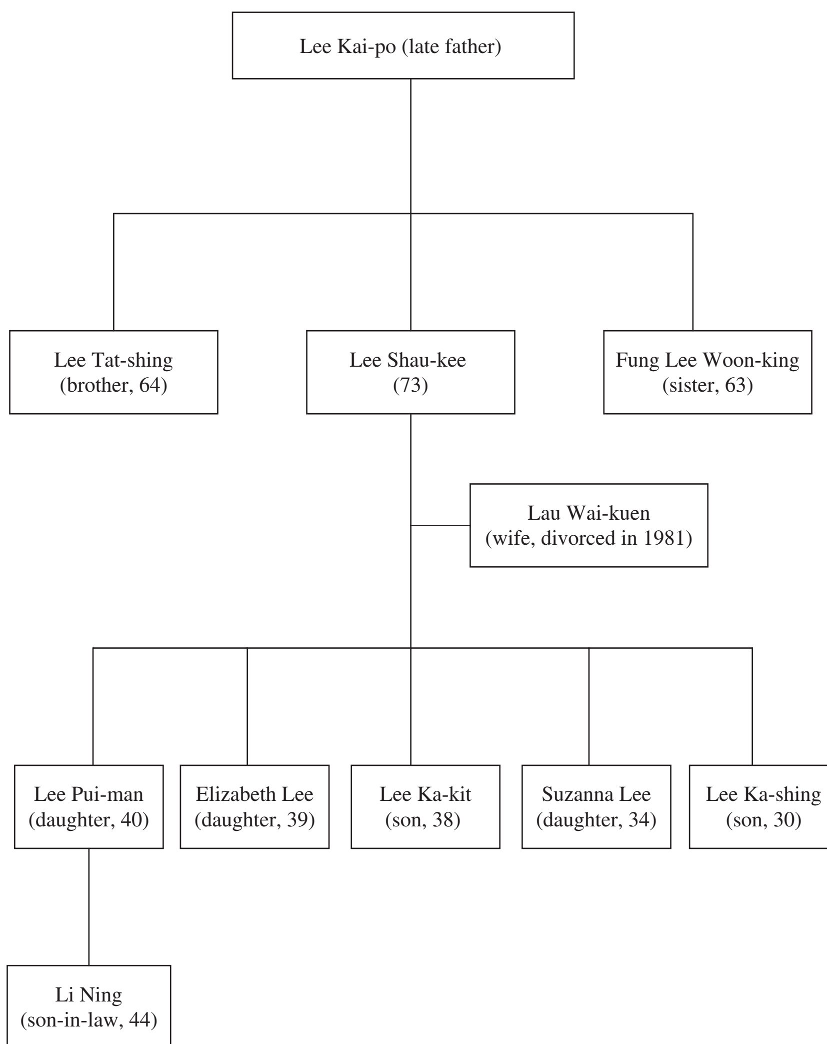
Note: This figure describes the control structure of the Henderson group. Lee Shau-kee and family have the ultimate control of the Henderson group. The Lee family's control of each group company is indicated by the percentage in the solid line. The titles of Lee Shau-kee and his family members in each group company are provided inside the box. Family ties with Lee Shau-kee appear in parentheses.

Figure 12.2 Control of the Henderson group (Hong Kong)

family controls the group through a pyramid structure. The Lee family controls 65.15 per cent of Henderson Land Development directly and Henderson Land Development, in turn, has 63.4 per cent control of Henderson China Holdings and 74.92 per cent control of Henderson Investment. The Lee family also controls indirectly the three publicly held companies of the group through Henderson Investment. Henderson Investment has 37.44 per cent control of Hong Kong & China Gas, 43.67 per cent control of Miramar Hotel & Investment, and 33.17 per cent of Hong Kong Ferry.

The Henderson group is a typical conglomerate controlled by a close-knit family (Figure 12.3). Lee Shau-kee has two sons, three daughters, one brother and one sister. The Henderson group is a typical family-run business with seven relatives of Lee Shau-kee holding senior positions in the group. Except for Miramar Hotel & Investment and Hong Kong & China Gas, we classify the other four companies in the Henderson group as family-run firms because the Lee family has more than 20 per cent control of each company in the Henderson group. In addition, the four companies are managed by Lee Shau-kee and his relatives. The line of family succession for company control could not be clearer in those four companies. Like any traditional Chinese family, Lee Shau-kee favours his eldest son (Lee Ka-kit), not his eldest child, to be the successor of the Henderson group. Lee Ka-kit holds several key executive positions in the Henderson group. He is the chairperson and president of Henderson China Holdings and vice-chairperson of Henderson Land Development and Henderson Investment. In addition, he is also elected as a non-executive director in Hong Kong & China Gas. Lee Shau-kee is also grooming his younger son (Lee Ka-shing) as a potential successor of the group. Lee Ka-shing is an executive director in three companies of the Henderson group.

Besides, Lee Shau-kee has elected his eldest child (Lee Pui-man) as a corporate executive in the group. She is the head of the marketing department in Henderson Land Development while her husband (Li Ning) is the executive director of three key companies in the Henderson group. Lee Shau-kee's siblings also hold director positions in the parent company of the Henderson group. We classify Miramar Hotel & Investment and Hong Kong & China Gas as individual firms because Lee Shau-kee has appointed professional managers instead of his relatives to run these firms. It seems that Lee Shau-kee has not designated his family members as successors in these firms despite his significant ownership stake. We argue that ownership is separated from control in these two companies and that Lee Shau-kee is simply the largest shareholder. In the case of Miramar Hotel & Investment, Lee Shau-kee is the only person in the Lee family holding any position in that company. Besides, he has adopted a non-executive



Note: This figure describes the family tree of Lee Shau-kee, the controlling shareholder of the Henderson group. Family relationship with Lee Shau-kee and age of his family members appear in parentheses.

Figure 12.3 Family tree of Lee Shau-kee

instead of an executive director position in that company. In the case of Hong Kong & China Gas, although Lee Shau-kee holds a non-executive chairperson position and his sons also hold non-executive director positions in that firm, none of them is managing the routine operation of the firm.

EMPIRICAL RESULTS

Table 12.4 presents the distribution of type of ultimate control according to 10 per cent and 20 per cent cutoffs for control of publicly held corporations in China, Hong Kong and Taiwan. Our results suggest that family-run firms are most pervasive in Hong Kong and are the least common in China. At the 10 per cent cutoff for control, Hong Kong has 43.45 per cent family-run firms, compared to 17.28 per cent in Taiwan and 0 per cent in China. The significance of family-run firms in Hong Kong relative to China and Taiwan is even clearer at the 20 per cent cutoff for control. At the 20 per cent cutoff for control, Hong Kong has 41.84 per cent of family-run firms, compared to 9.9 per cent in Taiwan and 0 per cent in China.

Our results on family-run firms for Hong Kong sample firms are consistent with CDL (2000) – our combined percentage for family-run and individual firms in the Hong Kong sample is 82.07 per cent (73.79 per cent) at the 10 per cent (20 per cent) level of control, compared to 64.7 per cent (66.7 per cent) at the 10 per cent (20 per cent) level of control for the CDL's sample. The fraction of family-run and individual firms in our Hong Kong sample is slightly larger than the CDL's sample because of the difference in composition in our sample. We believe that our sample of Hong Kong firms includes more smaller firms than the CDL's sample, where these smaller firms are more likely to be controlled by individuals or family groups.

However, our result on family-run firms in Taiwan is quite different from CDL's study. The combined percentage of family-run and individual firms in our sample of Taiwanese firms is 32.23 per cent (17.47 per cent) at the 10 per cent (20 per cent) level of control, compared to 65.6 per cent (48.2 per cent) at the 10 per cent (20 per cent) level of control for CDL's sample. One reason for the large discrepancy in results could be the difference in sample size. Our sample includes 515 corporations listed on the TSE, compared to only 131 Taiwanese corporations in the CDL's study. In addition, our inability to identify family ties and ultimate control for some Taiwanese firms might also explain the big difference in results. The missing information about family ties prevents us from establishing the ownership of a family group and biases our results toward reporting a smaller number of individual and family-run firms. We foresee the difficulty of studying ownership structure for publicly held firms in Taiwan, reasoning that neither

Table 12.4 Control of publicly traded corporations in China, Hong Kong and Taiwan

Country	Number of firms	Family-run	Individual (%)	Widely held (%)	Widely held corporation (%)	Widely held financial (%)	State (%)	Misc. (%)
Panel A: 10% cutoff for control								
Hong Kong	435	43.45	38.62	2.3	4.37	2.30	8.51	0.46
Taiwan	515	17.28	14.95	37.48	13.79	9.90	6.02	0.58
China	754	0.00	0.27[a]	1.06	11.94[b]	1.86	84.48	0.40
Panel B: 20% cutoff for control								
Hong Kong	435	41.84	31.95	11.72	3.68	2.07	8.28	0.46
Taiwan	515	9.90	7.57	64.47	8.35	4.47	4.66	0.58
China	754	0.00	0.13	6.23	10.61	1.86	80.77	0.40

Notes:
This table shows the distribution of publicly traded corporations according to types of ultimate control. We define a firm as family-run at the 10 per cent (20 per cent) cutoff for control if a person or a family group is the largest shareholder of the firm and controls 10 per cent (20 per cent) of the company shares. Besides, at least a person related to the largest shareholder by family ties holds a key executive position as chairperson, vice-chairperson, executive director, managing director, president, or senior manager in the company. We define a firm as widely held at the 10 per cent (20 per cent) cutoff for control if the largest shareholder controls less than 10 per cent (20 per cent) of the company shares. For non-family and non-widely held corporations, we divide the sample into five categories: individual, widely held financial, widely held corporation, state and miscellaneous corporation. A firm is defined as an individual firm if the largest shareholder is an individual. We define a firm as widely held financial (widely held corporation) if the largest shareholder is a financial institution (a corporation and non-financial institution) such as a bank, investment company, insurance company, or a finance company. We define a firm as state owned if the largest shareholder is the central government. For the rest of the firms, we classify them as miscellaneous. Panel A (B) presents the mean of each variable using 10 per cent (20 per cent) of ownership as cutoff for control.

[a] Only two companies are classified as individual corporations in China: Tsann Kuen (China) Enterprise and Hainan Airlines. Tsann Kuen (China) Enterprise is listed on the Shenzhen Securities Exchange and was co-founded by Wu Tsann-kuen, a Taiwanese businessperson, and one of his employees. The two founders hold the majority of company shares through two Hong Kong companies. The controlling shareholder of Hainan Airlines is American Aviation LDC, an American investment fund, which holds 14.8 per cent of the company shares. American Aviation LDC is reported to be controlled by the well-known American financier, George Soros.

[b] Two companies classified as widely held corporations are controlled by Hong Kong companies, not Chinese firms.

does the TSEC make disclosure of family ties and ultimate control of a firm mandatory, nor does the firm have any incentive to disclose such information for tax avoidance purposes.

We are not surprised to find an absence of family-run firms in China because of the various government regulations. However, we classify two Chinese firms as individual firms at the 10 per cent cutoff for control. One is Hainan Airlines where the ultimate shareholder is George Soros who controls Hainan Airlines indirectly through American Aviation LDC. The other one is Tsann Kuen (China) Enterprise where Wu Tsann-kuen is the ultimate owner of that firm as a major stakeholder in the company. The vast majority of the publicly traded corporations in China are state owned corporations. Over 80 per cent of the publicly held corporations in China are directly controlled by the central government. Of the sample Chinese firms, 10–12 per cent are classified as 'widely held corporations'. The percentage of state owned firms in China might be even larger because the ultimate control of the 'widely held corporations' and 'widely held financials' might be the central government, which we are unable to establish.

Table 12.5 presents the distribution of the type of ultimate control using the 10 per cent cutoff for control by market capitalisation for publicly held corporations in Hong Kong and Taiwan. We form ten portfolios based on market capitalisation of the firms in these two regions. The sample Taiwanese firms are slightly larger than the sample Hong Kong firms in each portfolio as indicated by their median market capitalisation. The only exception is the portfolio with the largest market capitalisation. While the share of family-run firms in not correlated closely with firm size in our sample of Hong Kong firms, the same share seems to decrease with the firm size in our sample of Taiwanese firms. Our results imply that the larger the firm size, the smaller the percentage of family-run firms and this correlation is applicable only for companies listed on the TSE. Consistent with Demsetz and Lehn (1985), ownership concentration decreases with an increase in firm size for publicly held corporations in Hong Kong. In the sample Hong Kong firms, the percentage of individual firms and percentage of widely held firms increases slightly with the size of the firm.

Table 12.6 presents the types of relationships in family-run firms using the 10 per cent and 20 per cent cutoffs for control for publicly traded corporations in Hong Kong and Taiwan. Our results show that the majority of family-run firms are close-knit with multiple family ties. Above 30 per cent and above 50 per cent of the publicly listed companies in Hong Kong and Taiwan, respectively, are multiple related. About 40 per cent of the sample firms listed on the HKSE and the TSE are either sibling or parent–child related. Most family-run firms that are parent–child or sibling related are usually second generation firms. The best example of parent–child related

Table 12.5 Control of publicly held corporations in Hong Kong and Taiwan by firm size

Firm size (Decile portfolio)	Number of firms	Median market value (US$ mil.)	Family (%)	Individual (%)	Widely held (%)	Widely held corporation (%)	Widely held financial (%)	State (%)	Misc. (%)
Panel A: Hong Kong									
1	44	1827.66	34.0	31.82	4.55	4.55	2.27	22.7	0.00
2	44	315.26	45.4	34.09	0.00	0.00	6.82	13.6	0.00
3	44	127.30	43.1	31.82	2.27	11.36	4.55	4.5	2.27
4	44	83.52	45.4	34.09	0.00	6.82	2.27	11.3	0.00
5	44	58.89	47.7	34.09	2.27	0.00	2.27	11.3	2.27
6	44	40.71	34.0	47.73	2.27	4.55	0.00	11.3	0.00
7	43	26.82	55.8	34.88	6.98	0.00	0.00	2.33	0.00
8	43	17.52	41.8	44.19	4.65	4.65	0.00	4.65	0.00
9	43	12.82	58.1	32.56	0.00	6.98	0.00	2.33	0.00
10	43	7.29	28.5	61.90	0.00	4.76	4.76	0.00	0.00
Panel B: Taiwan									
1	52	1732.43	7.69	13.46	44.23	15.38	3.85	13.4	1.92
2	52	506.60	15.3	19.23	32.69	13.46	9.62	7.69	1.92
3	52	242.47	19.2	13.46	36.54	13.46	11.54	5.77	0.00
4	52	150.34	13.4	23.08	32.69	17.31	7.69	3.85	1.92
5	52	103.17	23.0	9.62	44.23	11.54	5.77	5.77	0.00
6	51	70.97	17.6	9.80	37.25	13.73	13.73	7.84	0.00

Table 12.5 (continued)

Firm size (Decile portfolio)	Number of firms	Median market value (US$ mil.)	Family (%)	Individual (%)	Widely held (%)	Widely held corporation (%)	Widely held financial (%)	State (%)	Misc. (%)
7	51	52.11	21.5	9.80	35.29	19.61	9.80	3.92	0.00
8	51	33.28	17.6	17.65	33.33	15.69	9.80	5.88	0.00
9	51	21.09	21.5	17.65	39.22	5.88	15.69	0.00	0.00
10	51	9.42	15.6	15.69	39.22	11.76	11.76	5.88	0.00

Note: This table shows the distribution of publicly traded corporations according to types of ultimate control by firm size. We form ten portfolios according to the firm's market capitalisation as of 31 December, 2000, with the largest firms in portfolio 1 and the smallest firms in portfolio 10. We define a firm as family-run at the 10 per cent (20 per cent) cutoff for control if a person or a family group is the largest shareholder of the firm and controls 10 per cent (20 per cent) of the company shares, and if besides, at least one person related to the largest shareholder by family ties holds a key executive position as chairperson, vice-chairperson, executive director, managing director, president or senior manager in the company. We define a firm as widely held at the 10 per cent (20 per cent) cutoff for control if the largest shareholder controls less than 10 per cent (20 per cent) of the company shares. For non-family and non-widely held corporations, we divide the sample into five categories: individual, widely held financial, widely held corporation, state and miscellaneous corporation. A firm is defined as an individual firm if the largest shareholder is an individual. We define a firm as widely held financial (widely held corporation) if the largest shareholder is a financial institution (a corporation and non-financial institution) such as a bank, investment company, insurance company, or a finance company. We define a firm as state owned if the largest shareholder is the central government. For the rest of the firms, we classify them as miscellaneous. Panel A (B) presents the mean of each variable using 10 per cent of ownership as cutoff for control for Hong Kong (Taiwanese) corporations.

Table 12.6 Types of family relationships in family-run firms in Hong Kong and Taiwan

	10% cutoff for control		20% cutoff for control	
	Hong Kong	Taiwan	Hong Kong	Taiwan
Number of corporations	189	89	182	51
Parent–child (%)	21.16	22.47	20.87	21.57
Sibling (%)	25.40	19.10	26.37	19.61
Spouse (%)	11.64	2.25	10.99	1.96
Distant relative (%)	9.52	1.12	8.79	0.00
Multiple (%)	32.27	55.06	33.52	56.86

Note: This table shows the distribution of type of family relationships among publicly traded family-run firms in Hong Kong and Taiwan. We define a firm as family-run at the 10 per cent (20 per cent) cutoffs for control if a person or a family group is the largest shareholder of the firm and controls 10 per cent (20 per cent) of the company shares and if, besides, at least one person related to the largest shareholder by family ties holds a key executive position as chairperson, vice-chairperson, executive director, managing director, president, or senior manager in the company. We define a family-run firm as parent–child related if any member of the board of directors is related to the controlling shareholder as a parent or a child. We classify a family-run firm as sibling (spouse) related if any member of the board of directors is related to the controlling shareholder by family ties, as either brother or sister (husband or wife). We define a family-run firm as distant relative related if any member of the board of directors is related to the controlling shareholder by family ties, except for parent–child, sibling, and spouse relationships. We classify a family-run firm as multiple related if there is more than one type of family relationship in the corporation.

family-run firms is the Cheung Kong group, the largest business group in Hong Kong. The ultimate control of the Cheung Kong group is the Li Ka-shing family. Li Ka-shing has two sons: Li Tzar-kuok and Li Tzar-kai. He has chosen his eldest son (Li Tzar-kuok) as the only successor of the Cheung Kong group. None of Lee Ka-shing's other family members holds senior positions in the Cheung Kong group. The best example of sibling related family-run firms is the Sun Hung Kai group, the third largest family-run firm in Hong Kong. The ultimate control of the Sun Hung Kai group is the Kwok brothers (Walter Kwok, Thomas Kwok and Raymond Kwok), who inherited the company fortune from their late father (Kwok Tak-seng). Walter Kwok (the eldest brother) holds the chairperson and CEO positions while his two younger brothers occupy the vice-chairperson and managing director positions in the Sun Hung Kai group.

To explore further the determinant of family-run firms particularly in a fixed institutional setting, we examine the effect of firm age and firm size on the formation of family-run firms in a region. In Table 12.7, we present the coefficient estimates for a probit regression of the determinant of

Table 12.7 Probit regression of the determinant of family-run firms in Hong Kong and Taiwan

	Predicted sign	Hong Kong			
		10% cutoff for control		20% cutoff for control	
		Coefficient estimates (p-value)	Coefficient estimates (p-value)	Coefficient estimates (p-value)	Coefficient estimates (p-value)
Intercept		0.303***	0.362	0.460	0.492
		(0.00)	(0.61)	(0.52)	(0.49)
FirmAge	+	– 0.0063**	−0.020***	−0.008**	−0.020***
		(0.03)	(0.00)	(0.00)	(0.00)
Firm Age^2	+	–	0.000136**	–	0.00014**
			(0.04)		(0.05)
LFirmSize	−	−0.031	−0.0035	−0.0446	−0.017
		(0.88)	(0.99)	(0.83)	(0.93)
(LFirmSize)^2	−	0.004	0.0026	0.0044	0.0027
		(0.76)	(0.85)	(0.76)	(0.85)
Log Likely		−282.97	−281.05	−280.58	−278.70
number of observations		418	418	418	418

Notes:
This table presents the probit regression analysis of the determinants of family-run firms at 10 per cent and 20 per cent cutoffs for control for publicly held corporations in Hong Kong and Taiwan. The dependent variable is a binary variable representing the firm's choice of organisational form: one if a firm is classified as family-run; zero otherwise. FirmAge is the firm's year of incorporation through the year 2001. FirmAge^2 is the square of the firm's year of incorporation. LFirmSize is the log of market capitalization at the last trading in 2000. (LFirmSize)^2 is the square of the log of firm size. P-value statistics appear in parentheses. ** and *** indicate the measure is significantly different from zero at the 5 per cent and 1 per cent levels, respectively.

family-run firms in Hong Kong and Taiwan. We expect that older firms will be more likely to be family-run when the founding member of the family is old enough to consider family succession for the company's top executive position. Founding families concern themselves with succession primarily when the founder is old enough to retire. Thus, we expect that founder families will find their designated successor when they become older. We proxy age of the founding family by firm age. We include a quadratic term in firm age to capture any non-linear relationship, which might arise for firms older than two generations. We also expect that firm size to be negatively correlated with the probability of the business being a family-run firm. We argue that if family-run firms indeed consume private benefits by appointing family members as the companies' key executives such appointments will

Taiwan			
10% cutoff for control		20% cutoff for control	
Coefficient estimates (*p*-value)	Coefficient estimates (*p*-value)	Coefficient estimates (*p*-value)	Coefficient estimates (*p*-value)
4.212***	5.100***	3.64**	4.59***
(0.00)	(0.00)	(0.05)	(0.02)
−0.016***	−0.081***	−0.012	−0.0862**
(0.00)	(0.01)	(0.06)	(0.02)
–	0.0011**	–	0.00121***
	(0.02)		(0.04)
−0.764**	−0.740	−0.555	−0.522
(0.05)	(0.06)	(0.21)	(0.25)
0.049**	0.046**	0.0366	0.0329
(0.04)	(0.05)	(0.18)	(0.23)
−228.03	−224.82	−162.05	−159.36
507	507	507	507

lower the market value of the firm and in turn the wealth of the family group because of their holdings of the firm. The loss in firm value is larger in absolute scale for larger firms than for smaller firms. Thus, founding families of larger firms are less likely to appoint their own relatives as the designated successor than founding families of smaller firms.

Our results show that firm age is not linearly correlated with the probability of the business being a family-run firm but non-linearly in a U-shaped manner. Regardless of the cutoff level for control and origin of a region, firm age and the square of firm age are both statistically significant at the 5 per cent level in all equations with quadratic terms in firm age. For our sample of Hong Kong firms, the probability of a business being a family-run firm decreases with firm age when a firm is younger than 73.5 years old. However, it increases with firm age when the firm age is over 73.5 years old. For our sample of Taiwanese firms, the turning point is much smaller. The probability of a business being a family-run firm decreases (increases) with firm age when a firm is younger (older) than 36.8 years old. We also estimate the probability of a business being a family-run firm at the 10 per cent cutoff for control. For an average Hong Kong firm, the probability of a business being a family-run firm is 0.67 per cent if the firm age increases by one year. Similarly, the same probability is 0.66 per cent

for an average Taiwanese firm.[13] Unexpectedly, firm size is not significantly correlated with the probability of a business being a family-run firm. Except for the coefficient estimates for firm size variables at the 10 per cent cutoff for control for our sample of Taiwanese firms, none of the other coefficient estimates for firm size is significant at the 5 per cent level. It appears that a donor's bequest motive particularly in the form of a stake in the company is independent of firm size, that is, the size of the bequest in most cases.

CONCLUSIONS

To the best of our knowledge, this is the first paper to identify and document the prevalence of family-run firms in China, Hong Kong and Taiwan. The pervasiveness of family-run firms in these regions is related to their institutional differences regarding wealth conservation across generations and regulation regarding ownership concentration. Overall, we argue that China has the least and Hong Kong has the most favourable environment for the formation of family-run firms. In China, regulation that prohibits an individual investor from controlling a publicly held company through his/her ownership and the government's preference for listing State Owned Enterprises on the Chinese stock market limit the formation of publicly held family-run firms. Since ownership concentration of publicly traded corporations is permitted in Hong Kong and Taiwan, the formation of family-run corporations is related to the costs of wealth conservation across generations. We argue that the cost of wealth preservation is lower in Hong Kong than in Taiwan because of its lower tax rate on inheritances and gifts and the ease with which one can avoid these taxes.

Our empirical findings support our claim. We find that family-run firms are most common in Hong Kong and least common in China. We also find that the majority of family-run corporations are close-knit with multiple family relationships. The most common types of family relationship in family-run firms are either sibling related or parent–child related. We also find that firm age is related to the probability of a business being a family-run firm in a U-shaped manner. For younger (older) firms, the firm age is negatively (positively) correlated with the probability of a business being a family-run firm. We find no evidence that the formation of family-run firms is correlated with firm size.

While we document the significance of family-run firms in these regions, little is known about the performance of family-run firms versus professionally managed firms. Are the family-run firms more likely to consume private benefits than non family-run firms? If family-firms consume private

benefits, in what form of private benefits do they consume? Besides, what corporate governance structure can prevent the family-run firms from consuming private benefits?

NOTES

* We thank Andy Davenport for his comments and Wenjing Chang, Jengfang Chen, Taiyuan Chen and Dandan Wang for their excellent research assistance.

1. For clarity of presentation, throughout the chapter, we refer to a firm as a family firm according to the ownership of the largest shareholder in that firm. We impose a stricter requirement for family-run firms. We refer to a firm as family run if the largest shareholder meets the ownership requirement. In addition, the controlling shareholder and her family member(s) are also running the routine operation of the firm.
2. The size of Hong Kong is about five times the size of Washington DC in the United States with an area of 1089 square kilometres. Kowloon is a peninsula north of Hong Kong island with an area of 47 square kilometres. New Territories starts at the northern part of Kowloon and extends up to the southern border of mainland China with an area of 796 square kilometres.
3. Cantonese is a Chinese local dialect originating from Canton, a province of China.
4. The Chinese government directly controls the types of companies that are listed on China's stock exchanges. To be eligible to list their stock on China's stock exchanges, firms must obtain approval from various government agencies such as the China Securities Regulatory Commission, State Planning Committee, and State Economic System Reform Commission. Most of the firms that have obtained the approval are state-owned firms. Besides, the Chinese government uses quotas to allocate company listing according to the geographic and economic distribution of the SOEs in the nation. For example, each province and major city has a certain quota (namely, two for each province annually) to list their SOEs on China's stock exchanges, adjusted for the economic or political influence over the central government. Having companies listed on the stock exchanges sometimes becomes important to the local governments because they report the number of publicly listed firms in the region as a demonstration of regional political and economic success. Most private firms still have to get their funding from banks or private sources.
5. Historically, the SOEs are poorly and inefficiently run and they have become a heavy economic burden to the Chinese government. The Chinese government decides to reduce its burden by divesting state assets in SOEs. The stock market is used to raise capital from the general public and decreases the state involvement in the SOEs, which are subjected to market forces.
6. Although *inter vivos* gifts are exempt for estate duty purpose in Hong Kong if the recipients receive the gifts above three years prior to the death of the donors, *inter vivos* gifts are not exempt from stamp duty. Stamp duty is a tax on the transfer of assets and the top marginal rate for stamp duty in Hong Kong is 2.75 per cent.
7. Recently, politicians in Taiwan have been debating the merit of abolishing the inheritance tax.
8. Similarly to Taiwan, in Hong Kong, income and inheritance duty are exempt for donations to charitable trusts and foundations. However, charitable trusts and foundations are seldom used to avoid inheritance taxes. It is because establishing offshore trust funds is a more efficient method of avoiding estate taxes than establishing charitable foundations and trusts in Hong Kong.
9. In China, publicly listed companies can issue up to three types of shares with the approval of the China Securities Regulatory Commission (CSRC). The most common type is the A Share, which is denominated in Yuan (mainland China's currency) and sold

to the public investor in mainland China. The second type is the B Share, which is denominated in foreign currencies, usually US dollars, and originally sold to investors outside mainland China. The ownership restriction on B shares has been lifted since 2001. Currently, public investors in mainland China can also invest in B shares. The third type of share is the foreign share such as H shares and N shares, which are shares of Chinese companies that are listed on the HKSE and the NYSE, respectively, and hence denominated in Hong Kong and US dollars, respectively.

10. The China Securities Regulatory Commission (CSRC) is the official government agency that regulates stock exchanges in China. The website www.cninfo.com.cn is the official web-site mandated by the CSRC that publishes all publicly available information about Chinese public listed companies such as public offering prospectuses, annual reports and company profiles (including company background, profiles of insiders and the composition of ownership of the top ten shareholders).
11. Family relationships among key executives and members of the board of directors are not required to be disclosed in annual reports under the current regulations. We review the names of the company's board of directors and senior managers from the TEJ data bank and identify possible family ties among corporate insiders by their last name. If we cannot identify the exact family relationship for persons with the same last name, we conduct telephone interviews for verification. We expect some measurement errors for classifying family firms for companies listed on the TSE, especially for more distant relationships such as father-in-law and son-in-law.
12. In 1997, Forbes named Lee Shau-kee as the fourth wealthiest businessperson in the world. The top three wealthiest businessmen for that year were Bill Gates of Microsoft, Sam Walton of Wal-Mart stores and Warren Buffet of Berkshire Hathaway.
13. We compute the change in probability of a business being a family-run firm in response to a unit change in firm age while evaluating other variables at their medians. The change in probability can be expressed as $(\phi(X'\gamma)(\beta_1 + 2\beta_2 \text{FirmAge}|_{\text{median}})$, where $\phi(X'\gamma)$ is a normal density function, $X'\gamma$ is a matrix notation for sum of product between coefficient estimates and variables evaluated at their median, β_1 is the coefficient estimate for firm age, β_2 is the coefficient estimate for the square of firm age and $\text{FirmAge}|_{\text{median}}$ is the median firm age for the respective sample.

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13. Globalisation and institutional change in the Australian labour market

Kyle Bruce

INTRODUCTION

It is widely agreed that the forces of globalisation have induced substantial changes in Australia's (and other countries') domestic macro and microeconomic management, most notably in the conduct of trade, industry, and monetary and fiscal policies. Part of this phenomenon is a dwindling role for government socioeconomic involvement and a substantial move towards neoliberal policy guidance. One area where this has, and continues to be, apparent in Australia is in the labour market. After almost a century of state-coordinated, centralised determination of wages and conditions and a relatively high density of trade union membership, the last decade has seen far-reaching deregulation (or more realistically, re-regulation), decentralisation, a shift in power towards employers and an emasculation of union power. In this way, Australia has moved into and/or been drawn into a global transformation of industrial relations systems (Erickson and Kuruvilla, 1998; Bray and Murray, 2000).

As a starting point, this writer shares the views of Rodrik (1997) and also Champlin and Olson (1999), that the debates surrounding globalisation are much more than an ideologically charged discussion of the virtues of free trade: globalisation is a question of fundamental change in the cultural and political institutions governing a society. It might easily be argued that globalisation in any country, let alone Australia, is a result of the inevitable march of economic progress personified by technological and structural change, the spread of IT and an increase in tourism and in international trade and finance. Yet technological change in and of itself does not signify the need for a wholesale re-evaluation of the socioeconomic institutional underpinnings of a society, particularly the role of state and market in policy decisions, based on the premise of the inevitability of globalisation. The correlation between globalisation and institutional change in Australia

has been particularly strong for the simple reason that a globalisation paradigm has emerged in the last couple of decades as the basis for guiding economic policy. Since the mid-1980s both policy-making organisations and the actual operation of policy itself have been shaped by a bipartisan globalisation imperative (Bell, 1997, 2000; Argy, 1998).

The impulse for institutional change in Australia crossed ideological and political boundaries. For it is tempting to blindly subscribe to a 'new institutionalist' view of change exposited, for instance, by North (1994), wherein rent-seeking individuals (and/or their representative organisations), perceiving they could achieve higher payoffs, undertake an alteration or restructuring of exchange relationships, and thus the institutional settings or rules of an economy be they economic or political. In other words, it is important to stress from the outset that the impulse for changing the institutional underpinnings of the Australian economy, particularly the labour market, was not solely the consequence of the new dictates of global capital but more so the product of an evolving change process shaped by broad social, ideological and economic developments (Burgess and Macdonald, 1998).

Part of this change process has been an increasing acceptance amongst policymakers of neoliberal beliefs in the efficacy of freer domestic and international markets, deregulation, privatisation, microeconomic reform, and so on, in economic management. This has been labelled 'economic rationalism', a term peculiar to Australia. So it is that we have witnessed in this country an extensive 'deregulation' of the labour market, deregulation of financial markets, privatisation and corporatisation of government business enterprises (particularly utilities and state and local government services), a lowering of tariffs, an ethos of surplus budgets, and the rise of price stability as the *sine qua non* of monetary policy; all broadly in line with the policies of international organisations such as the World Bank and the IMF as to what constitutes sound economic management.

Mindful of the hazards of attempting to establish causality amongst the dynamic and intertwined threads of globalisation and institutional change, the focus in this chapter is on institutional change in the Australian labour market achieved through legislative deregulation and corresponding developments in the culture of how wages and conditions are determined. It is a stock-take of the transformation since the late 1980s or early 1990s in the institutional underpinnings of the Australian labour market, possibly engendered by the influences of globalisation. In short, it focuses on changes in the formal and informal rules or procedures governing the labour market and the resultant socioeconomic outcomes of the last decade or so, focusing on areas such as labour productivity, labour standards, employment levels and wage inequalities/disparities.

It is concluded that much of the institutional change enacted under the banner of labour market reform has achieved little in the way of its intended consequences.

THE CONVENTIONAL WISDOM CONCERNING GLOBALISATION

There is no denying progress, as the maxim goes. If one is referring to the breaking down of international trade and investment barriers and freeing up the flows of financial capital, then the record of progress is indeed impressive. For instance, between 1990 and 1999 the worldwide growth in merchandise trade grew by 6 per cent per annum, services trade by 10 per cent per annum, and foreign direct investment (FDI) grew by 12 per cent per annum (Greenaway and Nelson, 2000). Individual socioeconomic systems have become more intertwined than ever before due to the decline in human-designed barriers to trade, the rapid fall in the cost of communication and transportation, the rationalisation and fragmentation of production processes, and impressive economic growth. These events are not the subject of widespread dispute: instead it is the wide array of views as to their consequences that currently fuels debate.

If we subscribe to the conventional or mainstream trade theory then the benefits of international trade liberalisation and increased FDI are self-evidently beneficent and wide-ranging: freer markets and more trade are always better for all of society. The theory is that trade brings about specialisation, and so a more efficient allocation of scarce resources as countries exploit their relative comparative advantage. Trade also allows countries to exploit increasing returns to scale by virtue of focusing on a narrower range of tradable goods/services. Trade, by definition, also increases global competition and thereby dilutes the market power of domestic producers which means cheaper and more abundant goods/services for consumers. Finally, trade generates positive spillovers, such as technology transfer, on a global scale (Graham and Krugman, 1991).

The relevance of this theory to labour market outcomes is conveniently embedded in the seminal work on trade theory (Stolper and Samuelson, 1941; Mundell, 1957) which explored the relationship between globalisation and labour markets; in particular, labour's relative rewards from freer trade. A more contemporary incarnation of this story is provided by Wood (1998). Briefly, trade between developed and developing countries, based on skilled and unskilled human resources respectively, causes developing countries to specialise in the production of skill-intensive services or manufactured goods in which they have a comparative advantage because of

their relative abundance of skilled labour. They also reduce production of low-skilled or labour-intensive manufactured goods. Accordingly, in the developed country there is a rise in the relative price of skill-intensive services and goods such that the wage gap between skilled and unskilled workers widens. The converse occurs in developing countries.

There are several problems with this account, both theoretical and empirical. For one, it is a general equilibrium explanation with little to say about the adjustment process from pre- to post-trade equilibria: most obviously the effects of structural adjustment on workers in contracting industries such as lower incomes or loss of employment. At best, advocates of freer trade acknowledge this adjustment process contending that it is merely short-term and will be offset by the rewards reaped in expanding industries. The question then is framed in terms of how large these adjustment costs will be and what should be done about them in terms of public policy (Greenaway and Nelson, 2000; Champlin and Olson, 1999).

Empirically, and if we focus on FDI which has become viewed as complementary to trade, the pattern predicted by the theory advanced is not borne out in practice. The UN *World Investment Report* in 1998 tells us that flows of FDI were seven times as great in 1997 as in 1980, but that two-thirds of this investment takes place in *industrialised* countries and that just 10 countries account for half the flow of FDI. The comparative advantage account of developed countries trading with/investing in developing countries does not appear to be borne out in practice. Further, most of the FDI flowing into developing countries is not explained by specialisation on the basis of resource endowments, but rather by favourable host country policy changes (Champlin and Olson, 1999). As we will see in the following section, much of the impetus for globalisation is from the 'visible hand' of human-designed institutional change, rather than the invisible hand of market forces.

THE AUSTRALIAN LABOUR MARKET: RATIONALE FOR INSTITUTIONAL CHANGE

As mentioned in opening, a strong correlation exists between the onset of globalisation and substantial institutional change in the Australian labour market. From about the mid 1980s onwards a bipartisan socio-economic policy framework was developed that was decidedly more global and neoliberal in outlook. Part of this dynamic was a programme of labour market deregulation and industrial relations reform. Nearly a century of state-sanctioned, centralised (multi-employer) determination of wages and conditions with relatively high trade union density and relevance has

given way to a system today where in large parts of industry, wages and conditions are determined at the enterprise or firm level with little or no role either for state tribunals or trade unions.

These developments mark a fundamental change in the formal and informal procedures or institutions governing the Australian economy: a distinct legal and socio-cultural shift away from an isolated, inward-looking, collectivist, and state-dependent culture towards one decidedly more global in outlook and character, where the values of individualism and free competition are paramount. This is an important point, for as highlighted by Champlin and Olson (1999), globalisation 'is driven not by the irresistible natural law of markets, but by institutions'. As they note further:

> It is not *comparative advantage* based on natural endowments of factors of production that explains the recent shift towards FDI, but *competitive advantage* based on government policies, the historical development of industrial relations systems, cultural norms, and the undeniable bargaining power of large, transnational corporations (Champlin and Olson, 1999, italics in original).[1]

Driving (and/or driven by) this shift in values was a shared belief amongst economists and policymakers that immutable global forces necessitated a more flexible labour market devoid of institutional rigidity and excessive government interference. The reasoning was that highly regulated labour markets increased the costs firms faced in their hiring decisions, reduced employment levels, and slowed structural change so that the allocative task of labour markets was stymied. At a macroeconomic level and in line with the US and European experiences, the oft-cited argument for labour market deregulation was that Australia's above-average unemployment rate and poor labour productivity was due to a highly regulated and uncompetitive labour market. At a micro level, the arguments were similar, with Australian producers and their representatives arguing that they were unable to compete efficiently with offshore rivals due to the inflexibility of the labour market, particularly regarding matters of pay and hours of work. If we did not want to end up suffering from 'Eurosclerosis', the reasoning went, we had best adopt the US model of labour market flexibility.

Accordingly, in the late 1980s, the main avenue of external protective regulation of Australia's distinctive system of award-based pay and conditions came under fire from across the political spectrum.[2] For much of the twentieth century, employment conditions of the majority of Australian workers were governed via the distinctive system of compulsory arbitration and conciliation by quasi-judicial tribunals who determined highly prescriptive, legally binding multi-employer awards often

with little or no reference to conditions in individual workplaces. These awards were aimed at the industry or occupational level thereby promoting a high degree of uniformity across enterprises. The latter, it was widely believed, reduced the responsiveness of the labour market to changes in demand and supply conditions at the level of the firm and interfered with the signalling role of wages (Gahan and Harcourt, 1998; Campbell and Brosnan, 1999; Wooden, 2001).

Over the last two decades, this system of regulation has been all but dismantled via a series of bipartisan legislative changes so that today, industrial awards are merely 'safety nets' so that about 80 per cent of workers under federal awards and 50 per cent of those under state awards, are covered by individual or collective union or non-union agreements (Wooden, 2001). As Wooden observes further:

> (E)nterprise bargaining has thus supplanted arbitration as the dominant industrial relations paradigm. The new industrial relations landscape in Australia is one where national and industry-wide considerations are much more likely to be subordinate to the needs of enterprises and workplaces, and where employers and employees are expected to determine their own arrangements without significant involvement from tribunals. (T)his new landscape is one where trade unions are struggling to retain relevance (Wooden, 2001).

However, and more will be said on this later, part-time employees remain very much dependent on awards such that so-called 'safety-net' adjustments in wages remain an important vehicle for constraining wage inequality in the labour market (Preston, 2001).

COUNTER-ARGUMENTS TO THE LOGIC OF INSTITUTIONAL CHANGE

There are several problems with the logic behind the impulse for radical institutional change in the Australian labour market, particularly as concerns the desired effects on employment. The first point to be made is that the term 'labour market deregulation' is something of a misnomer. What we have seen in Australia is essentially a process of 're-regulation' with the state abrogating much of its role and transferring it to individual managers of workplaces so that managerial prerogative and the position of employers generally has been strengthened, while at the same time employment conditions and collective employment arrangements have been eroded. In other words, protective and pro-collective regulations have been supplanted by individualistic regulations. Furthermore, as Standing (1997) has argued, there is really no such thing as labour market deregulation anyway,

since even the most liberal labour markets have some level of institutional intervention.

The second problem, as conveyed by Agell (1999), is that when persistent social norms (informal institutional rules) are an independent and important cause of wage rigidity, the types of formal/legal institutional change emphasised in the politico-economic debate may actually accomplish very little, at least in the short term.[3] In Australia, much like Northern European countries such as Sweden, Denmark and Germany, much of the institutional underpinnings of the labour market have been, and continue to be, more reflective of the informal constraints shaped by historical norms, custom, and convention ('fair pay for a fair day's work') than of legally binding formal constraints. Furthermore, in an environment where state involvement in economic affairs is dwindling, there may actually be potential gains from these informal institutions that promote a rigid and compressed wage structure – they might be thought of as instruments of social insurance that protect workers against risks for which private insurance is hard to come by (Agell, 1999).

This is precisely the purpose of institutional intervention in the labour market: to protect and ensure some degree of equity, particularly in the face of global competition. So it is that the most 'open' economies are those with the most extensive institutional support. Rodrik (1997) has demonstrated that there exists a positive relationship between government spending as a proportion of GDP and exposure or openness to trade in 23 OECD countries. Similarly, Agell (1999) demonstrates that amongst comparable OECD countries, there is a positive relationship between openness to trade and trade union density and a negative relationship between openness and centralised wage determination: on average, countries more open to trade have sizable unions and more centralised wage determination. He also finds a link between openness and high minimum wages, strict job security legislation, and generous unemployment benefits. In other words, and contrary to the received wisdom amongst economists, labour market 'rigidities' may not be solely the result of rent-seeking behaviour amongst special interest groups like unions, but may form the basis of social insurance against the extremes of unbridled market forces, both domestic and international (Agell, 1999).

Robert Solow (1997) reached a similar conclusion. After critiquing the notion that labour market rigidity is often ill-defined and improperly held up as the cause of high unemployment, Solow used the distance of Beveridge curves (plotting the inverse relationship between job vacancies and the rate of unemployment) from the point of intersection of vertical and horizontal axes as a proxy for labour market rigidity. Comparing the Beveridge curves for the USA, the UK, France, and Germany from about

1960 to the early 1990s, he found that France and Germany do not seem to have suffered from noticeably more rigid labour markets during the high-unemployment 1980s than they did in the low-unemployment 1970s. They have high unemployment because they slid along their Beveridge curves not because of adverse outward shifts. In other words, high unemployment was the result of insufficient job creation, most likely caused by excessive and anti-competitive product market regulation, restrictive macro policy, and inadequate capital market discipline, a result confirmed by a McKinsey Global Institute study on France and Germany of which Solow was an advisor (Solow, 1997).

Australian labour economist Keith Hancock (1999) has similar thoughts on the matter; presenting basic findings that dispute the widely held notion that excessively high real wages cause high unemployment, he found little or no relationship between real wages and employment in Australia. In fact, using international comparisons of 10 OECD countries he found a *positive* relationship between employment and real wages. He also countered the widely cited argument that minimum wage laws cause inflexibility and compress wage differentials (between upper and lower income brackets) which, in turn, prevent lower-skilled, younger people from being employed. Greater wage dispersions are supposed to result in better employment outcomes, so the dominant reasoning goes. His international comparisons of 19 OECD countries show that this is not the case and some countries, Norway, Denmark and Sweden, for instance, have very good employment outcomes with markedly more compressed wages than in Australia (Hancock, 1999).

These studies indicate that the logic of institutional change of unadulterated labour market reform is unlikely to bring about a substantial increase in employment in Australia. This will be seen in the next section. But we must remember that this is only one of the rationales for change in Australia and that improving labour productivity in the face of more global competition was the other major aim. As we will also see in the next section, institutional change did, in fact, have this desired consequence. But at what cost?

CONSEQUENCES OF INSTITUTIONAL CHANGE

What have been the consequences of institutional change in the Australian labour market over the last 15 years or so? Far from impressive, it seems. In this section we survey the effects on labour productivity, employment, labour standards, and wage inequality/disparities. The only positive, it seems, is an impressive improvement in labour productivity, but even this

seems to be at the expense of labour standards, particularly job/income security. In this context, it is telling to recall Solow's (1997) comment on the efficacy of labour market deregulation in reducing unemployment:

> If pure unadulterated labour-market reform is unlikely to create a substantial increase in employment, then the main reason for doing it is the anticipated gain in productive efficiency, however large that may be. But if we respect the wage earner's desire for job security, and it seems as respectable as anyone's desire for fast cars and fat-free desserts, then an improvement in productive efficiency gained that way is not a Pareto-improvement.

In the Australian case institutional change has *not* resulted in a significant reduction in unemployment. The workforce has become increasingly 'casualised' which, along with the reduction in unionisation and the decentralisation of wage setting, has meant that job security has deteriorated and earnings inequality has increased.

Labour Productivity

The programme of micro and structural reform, and in particular the focus on industrial relations reform and flexibility from the mid 1980s and into the 1990s in Australia has resulted in an improvement in structural productivity in sectors such as transport, electricity and communications, and government business enterprises. Australia's multi-factor productivity in the 1990s was impressive at more than twice the OECD average (*RBA Bulletin*, various issues; Productivity Commission, 1999).

Turning to labour productivity, the reasoning behind institutional change was that increased flexibility brought about by decentralised (enterprise) bargaining would result in employers introducing more efficient work and management practices thereby improving technical efficiency. A survey of micro-level analyses of these issues conducted in Wooden (2000) reveals inconclusive results: individual managers are not convinced that productivity has actually improved in their workplaces. Yet at a macro level, increased flexibility is widely believed to be responsible for Australia's labour productivity pick-up in the 1990s. In this period, productivity in Australia doubled compared with the 1980s and was stronger than any comparable period since the 1960s. Australian's per annum growth rate in labour productivity of about 3 per cent in the 1990s was nearly double that of the much vaunted US performance of 1.8 per cent (*RBA Bulletin*, various issues; Parham, 1999; Dowrick, 1998). In a manner unique to Australia, labour productivity appeared to accelerate well above the trend in the 1990s due largely, if not entirely, to labour market reform (Dowrick, 1998).

Employment Levels

When we compare the average unemployment in the last three decades and also consider the trends of the past two years, the key rationale for labour market reform in Australia of reducing unemployment must be considered a failure. In the 1970s, unemployment averaged 3.7 per cent, it more than doubled in the 1980s at an average of 7.6 per cent, and averaged around 9 per cent in the 1990s. After hovering above 10 per cent for most of the early years of the 1990s (following a recession in 1990–91), unemployment was on a downward trend for the remainder of the decade reaching a low of just over 6 per cent in 2000. However, since then it has travelled on an upward trend, hovering between 6.5–7.5 per cent – just about back to where it was before the 1990–91 recession (ABS Cat. 6203). In other words, no serious inroads have been made in the stubbornness of our unemployment rate during the time-frame of the deregulation process, particularly if we consider that a growing proportion of the unemployed have been in that condition for a long period of time.

The most noteworthy facet of Australian unemployment in the last decade or so, therefore, is that the average *duration* of unemployment has risen substantially with the increase in the *rate* of unemployment, suggesting some form of hystereal force at work. For most of the 1980s, about 25 per cent of unemployed were long-term unemployed; in the 1990s, this jumped to about 30 per cent: the average duration of unemployment has more than doubled during the last two decades (Watson and Buchanan, 2001). At November 1999, about 30 per cent of the unemployed had been in this state for 12 months or more and about 18 per cent of this group of long-term unemployed have been unemployed for more than 2 years (ABS Cat. 6203).

In the context of employment levels, one of the great disappointments of the 1990s has been the failure of the Australian economy to create sufficient full-time employment. Over the decade 1991–2001, (average annual) employment growth was strong at 20 per cent but was concentrated mainly in part-time jobs. Over the past two decades in Australia, the part-time employment share has almost doubled (de Ruyter and Burgess, 2000). Furthermore, as at July 2000, 80 per cent of all male part-time jobs were casual; for females the corresponding share was 60 per cent. Between 1988 and 1998, casual employment increased by nearly 70 per cent (Preston, 2001).

Such is the recent record of non-standard and ‘casualised’ work in Australia. If we subscribe to the view that these are, in fact, the intended consequences of labour market deregulation, to make it more ‘flexible’, to give employers and employees greater freedom in their ‘buying’ and ‘selling’ decisions, then perhaps there is no problem. However, there are some

problems with this new-found flexibility. First, though there is no doubting the opportunities engendered by non-standard employment for parents with children and for students, they do not provide livelihoods for major income earners amongst the unemployed. Furthermore, and in contrast to the rosy portrait typically painted, this flexibility was to some extent imposed on a reluctant workforce. Research shows that about 30 per cent of part-time workers are in that position not for personal or family reasons, but because it is the only type of work available (Watson and Buchanan, 2001: 199). Many analysts believe that this represents a form of hidden unemployment.

The second problem of flexibility is the fact that part-timers are more likely to be reliant on awards, and so may experience slower wage growth (Preston, 2001: 170). Relatedly, there is a widening gulf between two-income and no-income households. Many of the new, mainly part-time jobs created in the 1980s and 1990s went to new labour market entrants, many of whom came from households with an existing 'breadwinner', rather than the unemployed. Accordingly, a widening divide now exists between families with no breadwinner and families with two job-holders (Dawkins, 1998: 319; Watson and Buchanan, 2001: 196, 198).

Finally, the third problem with labour market flexibility is the apparent increase in very long hours of work. Over the last decade the share of full-time employees working more than 49 hours per week has steadily increased; as at May 2001 some 30 per cent of full-time workers worked 49 or more hours per week (Preston, 2001: 157). There no longer seems to be such a thing as a 'standard' working week. However, no firm evidence was found by this writer to link longer hours and increased flexibility, a point emphasised by Wooden (2000: 135–43).

Earnings Inequality

In almost all developed economies since about 1980, the gaps between skilled and unskilled workers in terms of earnings and/or unemployment rates have widened. This rise in inequality has coincided with rapid globalisation and despite the assurances of some preeminent economists that the magnitude of trade flows are simply not large enough to engender the changes predicted by the model, there are good reasons to suppose that the relationship is causal (Wood, 1998). These adverse Stolper–Samuleson trade effects, emanating from massive import penetration by low-skill intensive goods from developing countries, have meant that employment and earnings in developed countries' manufacturing base have deteriorated. Increased trade results in both a decrease in demand for low-skilled labour in advanced economies, and also a flattening of demand for labour

because trade increases the degree of responsiveness (elasticity) of employers to wage levels via outsourcing or investing abroad. As Rodrik (1997) puts it:

> Taken together, an inward shift and a flattening of the demand curves for low-skilled workers reduce average earnings for low-skilled workers while increasing the dispersion of earnings among such workers and the volatility in wages and hours worked.

Has this been borne out in practice? In a much cited study using country-level panel data, Wood (1994) found a clear inverse correlation across developed economies between rising import penetration ratios and falling employment shares in manufacturing. Rodrik's overview (1997: 20–1) suggests that there is a link between wage inequality and volatility or variance in earnings. As for the Australian experience, a study by Karunaratne (1999) using dynamic time-series models of trade and technology, found that increased trade (and also skill-biased technological change) played a significant role in increasing wage disparity. This is confirmed by Norris and Mclean (1999) who demonstrated that between 1975 and 1998 the dispersion of earnings for full-time, non-managerial workers grew markedly, particularly for males. Lowest decile earnings as a percentage of median earnings declined by over 10 per cent, whereas highest decile earnings as a proportion of the median increased by over 20 per cent. These results are supported for 1991–8 by Preston (2001).

In the context of technological change, far from being simply the inevitable march of technical progress, some analysts believe that the growth rate of the relative demand for skilled labour in the past decades has accelerated well above its trend of the previous few decades and that this has been caused more by falling barriers to trade than by unrelated technological change (Wood, 1998). In other words, the immiserisation of low-skilled workers in manufacturing in terms of increased unemployment cannot be blamed solely on the cathartic forces of technological change: globalisation and the adverse Stolper–Samuelson trade effects must be considered as a primary culprit.

Labour Standards: An Overview

Despite the sanguine assessment of Lee (1996, 1997) that the international impact of globalisation on labour standards has been very modest, his definition of what constitutes labour standards seems to be restricted to unemployment and wage inequality which, as we have seen in the Australian context, have both deteriorated. Furthermore, if we take a

broader view of standards, we see that in addition to the problems of long-term unemployment and the pre-eminence of non-standard employment in Australia, as well as widening earnings inequality, job/income security, work intensity and/or hours of work, and levels of union protection, have deteriorated over the last decade or so. This is broadly in line with the European experience (Standing, 1997).

From the previous sections, a couple of salient points can be highlighted in the context of labour standards. Employment in Australia has become less secure and the divide between high- and low-income earners has become greater. These developments are linked, for the precarious nature of non-standard work erodes earnings potential and also the relative position of workers in the wage bargaining process. The latter, of course, has not been helped by the declining role of trade unions in the wage setting process.

Trade union membership in Australia has almost been halved in the 1990s, from 40 per cent in 1992 to 25 per cent in 2000. This is a consequence not only of structural factors such as union amalgamation, the decline in public sector employment, and the growth in low union-density type activities such as services, but it is also a direct result of the legislative assault on unions. As Burgess (2000) reports:

> (L)egislation has been enacted which makes it difficult for unions to organise and eases the path of employers towards de-unionisation and facilitates the shift from collective awards to individual employment contracts.

This was most visible in the 1996 Workplace Relations Act that facilitated non-union bargaining and individual employment contracts, a move found by the ILO to be in breach of international standards regarding encouragement and promotion of collective bargaining and also the convention on freedom of association (Burgess and Macdonald, 1998).

CONCLUSION

This chapter considered the logic behind, and the consequences of, institutional changes in the Australian labour market, arguing that although the dynamic of globalisation may not have directly caused many of the changes *per se*, it most certainly was responsible for the paradigm shift in policy, particularly as regards the labour market. What we have seen in Australia is a distinct shift in thinking as to how the labour market might be regulated: from a centralised, state-sponsored system of multi-employer bargaining where unions played a key role, to decentralised, firm-level

bargaining often directly between employer and employee. This marks a fundamental shift in power away from labour towards employers under the banner of catch-all, labour market flexibility. Some analysts believe that globalisation has been used as an ideological smokescreen for coercive action by the state, on behalf of organised capital, against domestic employment conditions and labour rights. Though this writer does not entirely share these sentiments, there is certainly some evidence for this view.

It seems that much of the institutional change enacted under the banner of labour market reform has achieved little in the way of its intended consequences. Labour productivity has improved but the rate of joblessness has remained stubbornly high, and the incidence of precarious, part-time and casual employment is at a high level. This, in conjunction with the dwindling relevance of unions and decentralisation of wage bargaining, has resulted in a marked increase in earnings inequality. These adverse developments have coincided with the winding back of public spending in Australia (under the banner of fiscal responsibility, another consequence of the globalisation imperative) underscoring the basic paradox in the current phase of globalisation, that at the very time a small, increasingly open economy like Australia needs more socialisation of risk it is being shifted back onto a growing low-wage stratum. This makes for uncertain times ahead in terms of social cohesion and stability.

NOTES

1. In this context, Cooke (1997) has suggested that among other factors, US FDI abroad was negatively affected by high levels of unionisation and centralised collective bargaining arrangements.
2. A fuller exposition of the process of change in the legislative arrangements for wage determination can be found in Campbell and Brosnan (1999), and also Hancock (1999a).
3. A similar discussion of this issue appears in Solow (1990).

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PART IV

Conclusion

14. Institutional change and empowerment under globalisation: some lessons learnt

Kartik C. Roy and Jörn Sideras

This volume has examined how institutions influence the process of empowerment of people under a given institutional framework and how globalisation influences these institutions. Conducive social and economic institutions are crucial to the success of any programme of empowerment and development. Social institutions change very slowly. However, during the last few decades, globalisation has had a contradictory influence on and implications for domestic institutions. For example in India the 'ideology of seclusion' acts as the most powerful institutional deterrent to women's empowerment, thus preventing women from achieving economic independence. Principally, the process of women's empowerment can be facilitated if the force of the 'ideology of seclusion' is weakened. The effect of globalisation on empowerment can be seen through its impact on domestic institutions, a phenomenon which has occurred in rural India. Also, in the United States, globalisation and the arrival of the information age are largely undercutting the traditional culture, which supported limited and subordinate roles for women. However, even in the case of a country such as the United States, the downsides of globalisation, for example the danger of regressive change, have to be carefully considered. Although slowly, globalisation has been weakening the force of the 'ideology of seclusion'. Generally speaking, and not surprisingly, under the influence of globalisation domestic institutions are slowly changing.

The editors of this volume have been particularly motivated by the fact that the effects of the integration of the world economy are being perceived in fundamentally different ways in the various global regions and that the proponents and critics of globalisation reach drastically different conclusions in addressing the ongoing process of the integration of the world economy. This book has focused on the role of domestic institutions in ensuring and facilitating global and equitable participation in the process of exchange in the era of globalisation.

It has become conventional wisdom among social scientists that the big issue is no longer whether institutions matter or not – they in fact do. Instead, the debate centres around which institutions are integral to a given nation's sustained development and prosperity. Owing to vastly different domestic (local) conditions and cultural backgrounds in the many societies around the world, the claim appears to be plausible that institutions have to be commensurate with the needs of the local situations. Thus, our approach has been twofold: to provide conceptual approaches to institutional diversity in a globalising world, mainly focusing on issues of citizens' participation and empowerment in the institutional-political realm, and to offer empirical analysis of institutional capacity in various socio-economic areas world-wide.

As mentioned above, the contributions to the first part of this volume have been theoretical fundamentals regarding the effects of institutions on human behaviour and on social stability in an environment of an ongoing integration of the world economy. The three chapters on the conceptual issues have in common emphasised the issues that are meant to contribute to the augmentation of socio-technological knowledge about modes of employment of local knowledge and experience in the process of institution building, implicitly or explicitly avoiding any kind of 'blueprint approach' for the development of the institutional set-up of societies suitable to meet the challenges of globalisation.

In Chapter 2, Dani Rodrik discusses types of institutions that allow the markets to perform adequately. He argues that although one can identify in broad terms what these are, there is no unique mapping between market and non-market institutions that underpin them, as the plausible variation in institutional setups is larger than is usually pre-supposed. After such general observations on institutions, Rodrik takes up the case of 'participatory democratic governance', analyses its impacts on economic performance and proposes appropriate institutions for achieving high levels of growth in a country. For building up institutions in a country, he stresses the need for greater use of local knowledge and experimentation than that of best practice 'blueprints', which may not cater to the unique needs of individual countries. He provides a range of evidence in support of his view that participatory democracies with their decentralised political systems are the most effective ones for processing and aggregating local knowledge, and for using such knowledge to achieve high quality growth: such democracies allow greater predictability and stability, are more resilient to shocks and deliver superior distributional outcomes.

However, such a democracy usually exists in a theoretical world, as, in many real-world democracies, new informal institutions are allowed by the political party in power to grow to destroy the force of formal

institutions, so as to enable that political party to stay in power indefinitely and collect rent. In such a situation a participatory democracy cannot function effectively unless the formal and informal institutions are congruent.

This brings us to a discussion of interaction between formal and informal institutions in Chapter 3. In this conceptual chapter Svetozar Pejovich has distinguished between formal and informal institutions and analyses the effects of the interactions between these forms of institutions on social stability and economic development. A testable theory – the interaction thesis – is developed to explain why less efficient countries do not necessarily duplicate the economic policies of more successful ones. The interaction thesis identifies the interplay of formal and informal rules as a principal factor affecting the economic stability and growth rates.

The book is also concerned with the relationship between political processes, which yield a significant proportion of the formal institutions in societies, and competition among jurisdictions, which is one of the controversially discussed features of globalisation. In his chapter Viktor Vanberg has examined the claim that the forces of globalisation and of ensuing competition among jurisdictions subvert the abilities of democratic governments to act in the interest of their citizens. Against this claim it is argued that competition among jurisdictions can, on the contrary, enhance the capacity of democratic governments to serve the *common interests* of their constituents by limiting the scope for rent-seeking and by functioning as a discovery process.

Thus these authors emphasise the importance of institutions in empowerment and development. According to them, people's participation in the operation of institutions, interaction between formal and informal institutions and competition between institutional jurisdictions are the three different ways in which institutions in respective countries can contribute to economic growth and sustainable development.

The second part of the book covers empirical findings. The contributions in this part contain analyses on the institutional conditions within specific countries representing all five continents and investigate institutional remedies, impediments and shortcomings pertaining to specific problem areas, as specified by the respective authors. The topics include issues such as financial institutions (Jennifer Holmes and Sheila Piñeres), the nation-state and political institutions in a globalising world (Michael Wohlgemuth), federalism in transformation (Richard Ericson), gender issues (Cal Clark and Janet Clark; Tabitha Kiriti, Clem Tisdell and Kartik C. Roy), the perils of privatisation (Jean-François Seznec), the structure of business firms (Kam-Ming Wan, Shi-Jun Liu and Hsihui Chang) and labour market issues (Kyle Bruce).

Cal and Janet Clark have looked into the impact of globalisation on women's role in American society. Their findings suggest that the status of women in the US is being notably affected by globalisation, revealing a mixed record of women's role in US society. In general, the growing premium on education has helped women improve their status in the economy. Globalisation and the transformation of the US into the information age are principally challenging and undercutting the traditional culture which supported limited and subordinate roles for women. On the other hand, the backlash against globalisation is centred on what Clark and Clark call a 'conflict of culture' that seeks to return to traditional values, especially regarding the role of women. Also, the dangers of an educational and digital divide, which may well go along with globalisation, are highlighted. Women who do not have access to education are perhaps more subject than men to marginalisation in the new economy.

Corruption is a problem that a number of democracies, especially newer ones, have to tackle. Jennifer Holmes and Sheila Piñeres examine the impact of financial institutions, and particularly of dollarisation, on corruption. Using public opinion data, historical analysis and economic data, they examine and compare the experiences of the European nations of Greece and Spain with the Euro with Latin American countries' experiences with dollarisation. They suggest that dollarisation, like the Euro, restricts the opportunity for corruption at the federal level by increasing transparency and budget discipline. Removing the ability of the government to create money restricts government's ability to choose programmes designed to buy votes.

In his chapter, Michael Wohlgemuth raises the issue of empowerment for a modern Germany which faces a threefold challenge: German unification, European integration and overall globalisation all put the German model of a social market economy to the test as all these historical processes entail intensified competitive pressures on German political and economic institutions. Institutions such as the German welfare state and its corporate structure as well as current attempts to build, in times of international economic integration, a European welfare state, are scrutinised. According to Wohlgemuth, empowerment cannot mean the delegated power of political representatives to engage in commanding market processes and outcomes. It rather means the establishment of institutions – local, national and beyond – that allow (groups of) individuals to engage in acts of economic and political self-organisation. Economic self-organisation takes place at all levels of competitive market processes, which, however, must rely on and be constrained by abstract rules of fair conduct. Political self-organisation, if it is to empower its citizens, has to be based on systems of decentralisation, subsidiarity, and inter-jurisdictional competition; principles and

processes that, again, rely on decisions about the constitutional structure of the polity on various levels.

Regarding the post-Soviet society, polity and economy Richard Ericson finds that despite strong central policies specifically aimed at integration into the international society and economy, political, social and economic institutions inherited from the Soviet era have reacted defensively, rejecting the alien imposition, a finding relating to Pejovich's interaction thesis. Although institutions formally changed, they retained much of the 'sovietised' character, particularly at the regional level. That is, the informal institutions that stand behind and give content to formal structures rejected much of the impact of globalisation, falling back on traditional (Soviet-based) industrial/economic networks and quasi-autarchic local substantive economics in many of the regions. Despite increasing pressure toward globalisation from the Russian federal government, domestic institutions are resisting change in the name of protecting the Russian people, even though that implies growing isolation and an increasing gap between world and Russian average standards of living.

Tabitha Kiriti, Clem Tisdell and Kartik C. Roy find that women in Kenya, who produce more than three-quarters of the region's basic foodstuffs, are adversely affected by globalisation. Traditionally, the economic, social and cultural environment in which they work is not supportive. In particular, women's access to agricultural inputs and support services has not improved commensurate with their role as farmers. Women's rights to arable land are weaker than men's. Labour remuneration also differs along gender lines, as the total income share received by men is over twice the share received by women. Women in Kenya are consistently under-represented in institutions at the local and national level. Especially in the present era of globalisation, women in Kenya are unable to benefit from the opening up of new markets because they lack property rights, especially land rights, which they could use as collateral for borrowing loans. Commercialisation of agriculture, characterised by a shift from household subsistence production to cash crops, has altered the gender division of labour and management of household resources. Globalisation also means that women who are mainly found in the informal sector and small-scale business cannot compete with goods from transnational corporations. Poverty, disease and increased levels of illiteracy especially among women are on the rise. Thus, the forces of globalisation have not improved the institutional environment in which women in rural Kenya survive.

The United States and many international organisations are calling for the countries in the Arab Persian Gulf to liberalise their economies and privatise the existing government ownership of these economies.

Certainly, less bureaucracy and more openness to private investments would incentivise the private sector and spur the very slow Gulf economies on. However, according to Jean-François Seznec, liberalisation and privatisation may not kick-start the Gulf economies. Using the Saudi Arabian example he argues that these present structures of heavy state involvement and ownership did not happen in a vacuum. The state became the major players in the economies as an answer to societal problems. Therefore, privatising without addressing these societal problems means that reforms are bound to fail. Pertaining to Saudi Arabia, Seznec maintains that unless the royal family members become ordinary citizens equal to all others under the law no amount of liberalisation will be useful or successful.

Kartik C. Roy's contribution has examined how institutions govern the lives of poor women in rural India and how globalisation affects these institutions. Poor women's lives in rural India are governed by a number of such institutional impediments, the most prominent among them being social customs and taboos. Generally, institutions set the conditions under which the process of empowerment works. Social customs and taboos exercise a strong influence on other institutional factors affecting women's empowerment such as education and property rights and so on. In this chapter, Roy discusses how the 'ideology of seclusion', embodying social customs and traditions, imposes gender based discrimination on women in their daily lives within and outside the surroundings of their homes for example, in pursuit of education and in exercising their property rights. The forces of the 'ideology of seclusion' need to be weakened to facilitate the empowerment process. Globalisation, by lessening the forces of the 'ideology of seclusion', can facilitate the empowerment process of women.

Kam-Ming Wan, Shi-Jun Liu and Hsihui Chang provide a comparative study of the family business and its implications in the Greater China area (China, Taiwan and Hong Kong). Family firms play an important role in the economic development of societies. However, closer observation suggests that the popularity of family business, as one form of business organisation, differs across societies and different development stages of economic development. This chapter first explains the economic rationale and viability of family firms. Wan, Liu and Chang maintain that unlike market exchange activities, family organisation tends to reduce the costs of contracting. This is particularly important for the survival of the family as an institution when the private property rights system is weak and information asymmetry is severe and hence contracting costs are high. This chapter then examines the implication of the theory in the context of the greater China area. Wan, Liu and Chang first contrast the prevalence of family firms in the Greater China area with that in the Western countries. They also attempt to explain the difference among the regions in the

Greater China area. Their chapter also compares the performance of family firms with the performance of non-family firms.

Mindful of the hazards of establishing causality amongst the dynamic and intertwined threads of globalisation and institutional change, Kyle Bruce's chapter is very much a stock-take of the recent transformation in the institutional underpinnings of the Australian labour market, possibly engendered by the globalisation process. In short, it focuses on changes in procedures or rules and the resultant economic outcomes of the last decade or so, focusing on areas such as labour productivity, labour standards, work intensity, non-standard employment, wage inequalities/disparities and unemployment. As the title suggests, the results are mixed, with improvements in labour productivity and labour standards, but with a deterioration in areas like job security, hours and conditions, wage equality and unemployment, particularly of the long-term and structural varieties.

Thus, in this volume, the chapters dealing with conceptual issues have espoused the need for centralised and democratic institutions which will be operated by the people with the appropriate support of informal institutions to facilitate people's empowerment. However, chapters dealing with empirical issues have highlighted the following facts:

1. Several countries are experiencing conflict between institutions and cultures as the old economic, political and cultural institutions are in the process of being replaced by new institutions. As a result some sections of the community which cannot adapt themselves to the new institutional environment are being marginalised.
2. Due to liberalisation of import restrictions, increasing inflow of goods and services into low-income as well as middle-income countries has been accentuating the level of poverty and deprivation of women in the informal sector and thereby adversely affecting their empowerment.
3. On the other hand, in other developing countries where restrictions imposed on women by cultural institutions have severely impaired their capacity to attain empowerment, globalisation has been weakening the forces of derogatory cultural institutions and thereby facilitating these poor women's empowerment.
4. In some middle- and high-income economies, due to the total dominance of the state over enterprise and society and the unwillingness of the state to liberalise the political and cultural institutions, any attempt to undertake some reform in the economic sphere may fail to achieve results.
5. For some countries, attempts to integrate rapidly with the global economy by removing controls on their currencies have severely destabilised their economies. Hence, it is suggested that bringing

the whole region under one hard currency can be a solution to their problems.

6. Finally, for some countries flexible production in small family farms accompanied by absence of institutional rigidities has reaped benefits for the countries under a globalised trading environment, whereas for others, breakdown of institutional rigidities particularly in labour market has produced good effects on productions but disadvantaged labours.

In Chapter 1, we stressed the need for countries to put in place appropriate institutional apparatus, to reap the benefits offered by globalisation and to minimise its adverse impact. Case studies of individual countries in this volume have highlighted this point. At the end of the day, if globalisation, despite creating some upheavals in the market system and society, can provide a country with net social and economic gains, which in turn can reduce the level of poverty and increase the level and coverage of empowerment, then the risk that globalisation poses is worth taking. It does create a disequilibrium in the market system. In Schumpetarian terms we can say, this is the 'creative destruction'.

Summing up

Despite all the debates that have been taking place among the scholars and policymakers around the world on the impact of institutional reform and globalisation on poverty alleviation and empowerment in developing countries, one has to admit, on the basis of the facts that have emerged, that institutional reforms and globalisation have resulted in certain profound impacts on all globalisers.

Evidence shows that the countries that have opened up to the rest of the world have done better than the others in terms of achieving higher economic growth and raising living standards.

International economic integration has promoted growth which, on average, has increased the incomes of the poor.

Globalisation has facilitated the spread of technologies which have contributed to remarkable improvements in health, life expectancy and literacy levels in poor countries. For example, infant mortality rates declined from 1970 on average by 50 per thousand in 1999 in developing countries, compared with a decline of 10 per thousand to reach 6 per thousand in 1999 in developed countries.

Between 1960 and 1999, life expectancy in China doubled to 70 years; in India, it rose by 20 years to reach 64 years; and in the United States it rose from 70 to 77 years.

During the last three to four decades, adult illiteracy rates have declined by 30 per cent in China, Korea, India, Ghana and Mexico.

The process of convergence of per capita incomes among countries has accelerated under globalisation. In the 1990s the per capita income of the globalisers of the developing world has grown by 5.5 per cent compared with a 2.2 per cent increase achieved by those in the developed world. Incomes of developed countries are also converging (Masson, 2001).

Hence are these developments to be welcomed? The answer must be in the affirmative.

We conclude with the following comments: economic theory as developed by the Hecksher–Ohlin–Samuelson model of free trade, points out that a fully integrated world economy provides the greatest scope for maximising human welfare. This proposition is based on the assumption of free international movements of goods and factors, and on the availability of information and a high degree of competition. Individual countries however, even in a globalised world economy of today, will, in their own interest, maintain some barriers to free movement of capital and labour. However, countries will continue to enjoy benefits from globalisation as long as goods are traded relatively freely in the globalised world economy.

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