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INSTITUTIONAL OBSTACLES TO LATIN AMERICAN GROWTH

Silvio Borner, Aymo Brunetti,
and Beatrice Weder

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PREFACE

The International Center for Economic Growth is pleased to publish *Institutional Obstacles to Latin American Growth,* by Silvio Borner, Aymo Brunetti, and Beatrice Weder, as the twenty-fourth in our series of Occasional Papers, which features reflections on broad policy issues by noted scholars and policy makers.

In this paper, the authors examine how the institutional uncertainties that plague Latin America get in the way of economic growth. What are the laws? Will they be enforced? Will they still be in effect a year from now? When these kinds of questions cannot be answered, economic activity suffers, for people cannot rely on the state either to enforce contracts or to keep its hand out of the economic sphere.

This paper summarizes the authors' preliminary results in a large-scale empirical investigation of the institutional preconditions for growth. In comparing institutional arrangements in Latin America, Southeast Asia, and Eastern Europe, Borner, Brunetti, and Weder have developed a theoretical framework that may prove extremely valuable for understanding the Latin American dilemma—and for overcoming it. It should also prove useful to professionals and policy makers who are faced with similar issues elsewhere in the developing world.

Nicolás Ardito-Barletta
General Director
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Panama City, Panama
February 1992

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SILVIO BORNER, AYMO BRUNETTI,
AND BEATRICE WEDER

Institutional Obstacles to Latin American Growth

Traditional analysis of Latin American development issues puts macroeconomic instabilities at center stage. This paper argues that institutional obstacles are now a much more crucial problem for the transition from stabilization to growth for most Latin American countries. Uncertainties about the nature and enforcement of the "rules of the game" can have devastating effects on private investment and specialization. Such institutional uncertainties arise when the executive has highly discretionary power to change the law and enforces it arbitrarily. Any reforms designed to enhance specialization and growth must first increase institutional certainty. Executive power must be made more contestable, in order to stabilize the institutional rules of the game and thus allow growth-enhancing interpersonal and intertemporal exchange.

In the first section of this paper we will show the relative decline of Latin American economies in the past several decades and consider the traditional explanations for this decline, which remain unsatisfactory.

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The second section offers a new approach for explaining differences in growth rates by concentrating on institutional factors. The third section shows that people in Latin America suffer from uncertain institutions that distort their expectations and have far-reaching consequences for economic transactions. In the fourth section we explain these institutional shortcomings, and in the fifth section we propose reforms that could allow Latin American countries to return to a stable growth path.

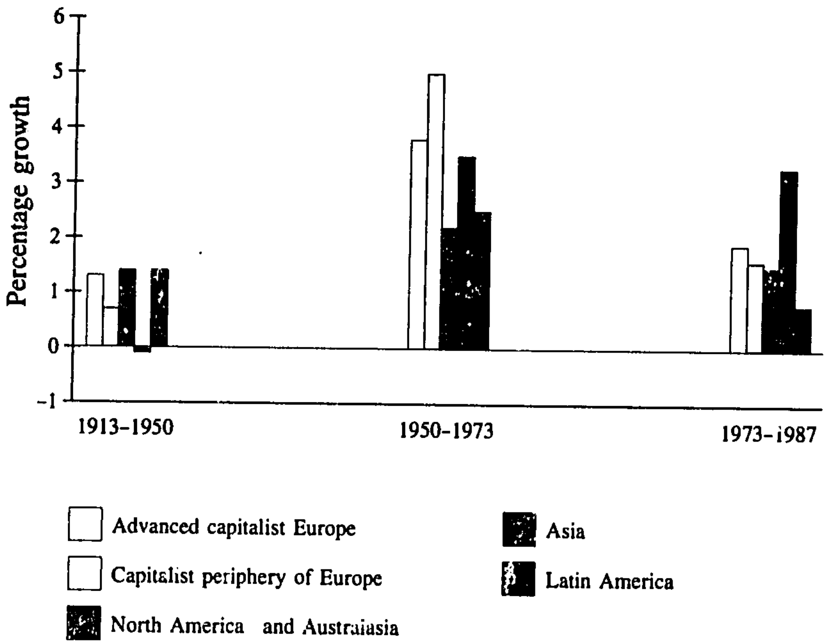
Development in Latin America: Potential and Performance

Catching up or falling behind? Latin American countries, to a large extent culturally rooted in Portugal and Spain, became independent around 1820. Thanks to their abundant natural resources, their economies grew rapidly relative to most other regions of the world until 1950. In fact, this rapid growth allowed some Latin American countries to temporarily surpass the colonial mother countries in terms of per capita gross domestic product (GDP) (Maddison 1991). The period between 1950 and 1973 marks an improvement in comparison with the interwar period, but a shortfall against the golden age in practically all "Western" countries in North America, Europe, and Asia.

A long-term comparison of per capita growth rates in five regions of the world in Figure 1 shows the relatively poor performance of Latin America. The beginning of the century saw the region keeping pace with Europe and North America. At the end of the century Latin America has fallen behind all four other regions. Since Latin American countries are still doing relatively well compared with large parts of the rest of the world, such as Africa, they are all classified as middle-income countries (World Bank 1990: 164). Yet the gap between potential and actual performance in the long run and the recent acute development failure have bred the term "Latin American disease."

The symptoms of the disease have been stated countless times since its open outbreak in the 1980s: the 1970s were years of heavy spending, with most of the foreign credits flowing into public consumption and capital flight (Balassa et al. 1986). One popular consumption choice of governments was the enormous "prestige" project. These white elephants can now be admired in almost every Latin American country.[1]

FIGURE 1 Average Annual Growth of GDP per Capita in Five Regions of the World, 1913-1987



SOURCE: Maddison 1991.

Government misallocation of resources is only one of the reasons Latin American countries were hit so hard in the 1980s. Another is found in the strategy of import substitution, which most countries had pursued since World War II. Under the intellectual leadership of the United Nations' Economic Commission for Latin America, the protective barriers against imports grew and with them grew import-substituting industries. In the beginning, the model of import substitution seemed to work quite well. And when the market capacity of the smaller economies was exhausted, the idea of substituting imports at the regional level became popular. In the long run, however, import substitution was economically and politically self-defeating. It created an illusion that was brutally destroyed in the 1980s when the inflow of external funds stopped abruptly and Latin American countries found themselves unable to generate the necessary exports in competitive world markets. The import-substituting industries never left the stage of infancy, and the interest groups representing these internationally uncompetitive industries now form a major obstacle to the liberalization process.

The predictions that the 1980s would become a "lost decade" have proven to be more than justified, leaving most Latin American countries with a per capita domestic output that declined by almost 10 percent (Economic Commission for Latin America 1989: Table 1). Most countries still face stagflation, high foreign indebtedness, severe liquidity and even solvency problems, and loss of creditworthiness with both foreign investors and domestic entrepreneurs, who prefer to hold their assets abroad (illegally, if necessary) rather than invest in their countries. In response to the shortfall of external capital, governments raised the internal fiscal deficits so high that there are severe limits to local borrowing. At the same time the inability of Latin American governments to tax income or expenditure forced them to look for other sources of revenue. The most popular income source for many a government during the 1980s was the inflation tax. Monetary expansion led to high and rising inflation, culminating in some countries in hyperinflation. A series of heterodox stabilization experiments made matters worse, because they betrayed the people who believed in the stabilization and distorted the relative price structure. The sacrifice that people were asked to make did not even yield the promised stabilization. Moreover, the adaptation of people's expectations limited the scope of the inflation tax, gradually depriving governments of this last source of revenue.

The 1980s were further characterized by a move toward democracy that swept the continent like a powerful wave. By the beginning of the 1990s, a historically unprecedented situation existed: every Latin American country had a democratically elected government. These democratic governments were, however, saddled with enormous problems. Their first task was to create stability. It seems, though, that democracy finds it inherently difficult to take harsh measures. Nevertheless, most of the countries with chronic inflation have experienced or are experimenting with some kind of textbook stabilization program.

The conclusion from this short overview can be summarized as follows: During the twentieth century, Latin America has seen a relative decline in its performance compared with other regions of the world that started from similar levels of per capita GDP growth. The greatest challenge for the 1990s is now to achieve a turnaround in the long-term development process by making the transition from stabilization to growth.

Traditional explanations and cures. For long periods of time Latin American economies developed (and in a certain way still do today) in relative isolation from the rest of the world. This isolation reinforced the notion that Latin American development problems are special cases calling for special theories or ideologies. Some interesting, yet at the same time dangerous, intellectual perceptions about the Latin American development process have resulted from this situation.

Ideas and ideologies have both played important roles in several widely held views on why growth and stability are so fragile in Latin America. The first line of thought is to take refuge in cultural or sociological explanations of Latin American development failures. Culture and society are, of course, important, but we firmly believe that they are much less decisive than many observers think. Furthermore, we are usually left with an ad hoc illustration of one particular country. Let us take the Spanish-Portuguese culture as an example. How can we explain the sudden surge of investment and growth in Spain by a change in culture? We will show in this paper that although the behavior of Latin American peoples differs widely, it is a mistake to take recourse to cultural factors (such as race and religion) too quickly. Rather we think that the institutional environment explains these behavioral characteristics quite well—and within an economic framework.

Another prominent line of thinking in Latin America sees external forces constraining development in a systematic or even purposeful way. Imperialist dominance, peripheral dependence, and export pessimism all belong to this category. There is no doubt that the external environment is tough and getting tougher. Nonetheless, the blaming of outside forces is not helpful, for these constraints can be influenced very little. A positive strategy is rather to increase one's own relative attractiveness.[2] We even postulate that the more adverse the external environment, the more important the relative attractiveness of a country's own institutions.

With the demise of socialism in Eastern Europe and the widespread liberalization in most areas of Asia, Latin American economists are becoming the last defenders of a simple "statist" view. They assume that states or governments are legitimate and capable actors, despite the long history of contrary experience. Again, we do not want to throw the baby out with the bath water; the state is an important actor. It should be strong—but small. It should be efficient—but limited.

In the following sections, we will examine the role of institutions and look at the necessary limitations of government power. Institutions have to be enforced in a predictable way by the state. The main issue, therefore, is not the state per se but rather the unchecked control it exercises over the economy as well as the people.

The Institutional Dimension of Growth

The rise and fall of neoclassical growth theory. Neoclassical growth theory poses a paradox for developing countries: according to one interpretation, it is the model for all times and all places and, therefore, is applicable to developing countries without modification. In another interpretation, its relevance is restricted to highly developed capitalist economies with efficient market and government institutions. The latter point of view leads to the question of the legitimacy of and necessity for a special development theory. Our approach will try to synthesize these two claims by making two arguments:

1. Growth theory should be able to explain the central forces of development for all countries; there cannot be different theories for different stages of development.

2. Traditional neoclassical growth theory is, however, not the appropriate framework, because it defines away many important determinants of growth by assuming the existence of the very institutions that are necessary preconditions for efficient markets.

What we are looking for is a general theory of growth that does not eliminate institutional aspects. But this by no means requires another theory. What we need is a general version of the special neoclassical growth theory. With this in mind, we shall try to sketch the basic features and problems of a mainstream growth theory and relate them to the issue of institutions in order to get a meaningful general development theory.

Economic growth was a central theme in the 1950s and 1960s. The high and relatively constant growth rates underpinned belief in steady-state equilibrium growth models that promised undisturbed development way into the twenty-first century. Robert Solow and others created the core of the neoclassical growth paradigm, which was extended and enlarged (Solow 1956). Based on a competitive one-sector model, Solow described an accumulation process in equilibrium that fit the stylized facts of growth surprisingly well. The driving force of this type of growth is basically the accumulation of labor.

This so-called vintage approach seemed to include technical progress by incorporating new technology in new capital (Solow 1960). Nevertheless, technical progress as such remained strictly exogenous and was defined and thus measured as a residual over and above what accumulation could account for. Ingenious economists invented trick after trick to reduce this residual by extending and differentiating the factors of production (growth accounting) within the framework of a production function. A second problem was the model's counterintuitive and also somewhat counterfactual prediction that the rate of investment was irrelevant to the rate of growth in the steady state (see, for example, Romer 1989: 10).

With the slowdown in global growth in the 1970s, research on growth issues came to an almost complete stop. Business cycles based on both supply and demand shocks came back into style. And with regard to development issues, exogenous or cultural barriers to development moved to center stage. Growth was a dead issue—both in theory and in politics.

In the course of the 1980s, the topic of growth was resurrected. Not only was the growth performance of different regions and countries very uneven, but development without growth also became unfashionable. Parallel to this political awakening a theoretical revival took place. Based on the progress in the realm of market equilibrium with imperfect competition, neoclassicists like Lucas and especially Romer succeeded in endogenizing technical progress by making it partly or wholly dependent on the rate of investment (Dixit and Stiglitz 1977; Lucas 1988; Romer 1986, 1989, 1990). Rather than discussing the technicalities of these models, we would just like to stress this link and remind the reader that some forms of positive externalities have to be assumed. This point will be discussed in more detail later. For now it is important to note that these externalities arise only if firms have an incentive to innovate. But in a world of monopolistic competition and costly research and learning processes, a legal framework permitting the investor or innovator to appropriate enough rent to make the risky effort worthwhile in the first place is required. The newest model of Romer clearly illustrates the importance of guaranteed property rights to create new knowledge, which—as an externality—can increase the growth process (Romer 1990). A firm that intentionally invests in research and development needs an incentive structure, such as a patent law. This institution gives the inventor the possibility of reaping additional rents and so creates the incentive to innovate. Romer does not expand this idea, but implicitly an entire institutional framework must exist behind his model. Obviously a patent law alone will not do the job. In other words, behind a law there must also be a credible and therefore powerful system of enforcement. Individuals will be ready to invest in research and development only if they strongly believe that the institutional setting is legally and politically in a position to enforce their claim on the temporary monopoly rent from the innovation. The importance of such institutions in providing the basis for economic growth seems so obvious and intuitive that it is difficult to understand why it has been neglected for so long.

The crucial role of institutions.

Defining institutions.

> It would be little exaggeration to say that while neo-classical theory is focused on the operation of efficient markets, few Western economists understand the institutional requirements essential to the creation of such markets since they simply take them for granted (North 1990:2).

The consensus on the centrality of institutions is not matched by one on their definition.[3]

We define institutions as rules of the game. Institutions are sets of rules that govern the behavioral relationship among individuals or groups. The institutional setting describes (1) the choice set an individual has and (2) the incentive constraints he faces in dealing with others. Institutions facilitate interaction among people by helping them to form expectations that each person can reasonably hold in dealing with others. Institutions may be formal—in other words, embodied in laws or organizations—but they may also exist informally as a consequence of repetition or custom.

The following stylized example will further clarify what we mean by institutions as rules of the game: in the colloquial use of the word institution, an auction would be called an institution. In our definition an auction would only be an organization. The term institution requires that the rules by which the auction unfolds are also stated. Since these rules are often almost second nature, they are understood when we talk about an auction; most people will think of an auction as a place where progressive oral price bids are made. In other words, each bid must beat the previous one by a minimal amount, the highest bidder gets the object and pays the price he announced, all the other bidders get nothing and pay nothing. There are, however, different sets of rules governing auctions. For instance, there is the first price sealed bid auction: everyone who wishes to bid for the object writes the bid on a piece of paper, seals it, and submits it. The highest bidder again wins the object and pays his bid. It is clear that these games have different equilibria. Therefore, people who are used to first price sealed bid auctions will have different expectations from those for whom the progressive oral auction is the norm. From this follows the need to clearly define the institution, or the rules of the game.[4] Let us consider a second example. A labor union, again, is not an institution, but an organization or an actor in the game. The way it interacts with the state or the employers may, on the other hand, be an institution if there is a rule or a regularity in the interaction.

The importance of the institution of the state. The institution of the state should be formally conceived to secure contracts between private parties. The need for a state can be understood easily if we start from a hypothetical situation of anarchy. In this case private contracting is very difficult because of the lack of enforcement. The parties have to resort to complicated patterns of enforcement such as social pressure, repeated interaction, or physical force. We will encounter this entire set of alternative enforcement mechanisms when we discuss the Latin American reality later. It will be shown that enormous gains from trade are forgone if contracting is limited by the availability of such private enforcement mechanisms. If there were a third party guaranteeing that contracts are carried out as agreed, everyone would benefit from the increased contracting possibilities. Starting from this state of anarchy, the emergence of the state can be explained by the preferences of the individuals (see, for example, Buchanan 1968).

The situation of anarchy can be represented within a so-called prisoner's dilemma. Although both parties may agree beforehand not to cheat, when playing the game each has a private incentive to cheat provided that the other party does not deviate from the agreed-upon strategy.

Let us take the example of the enforcement of property rights. There are two individuals, each of whom has an endowment of goods. Both may respect property rights and trade their goods with an exchange relation that reflects their relative preferences. This outcome yields hypothetical utility levels of 10 for both individuals (see Table 1). Or one may steal the whole endowment from the other and keep his own. This outcome yields 15 for the one that steals and –5 for the one that wanted to trade and whose goods have been stolen. Both parties usually have an incentive to steal if they assume that the other will trade. The equilibrium of the one-shot game is the worst of all possible outcomes: 0 for both.[5]

The main problem for both parties is their inability to precommit themselves to a strategy, because their commitment is not credible. One

TABLE 1 Prisoner's Dilemma

	Actor #1	
Actor #2	Trade	Steal
Trade	10, 10	–5, 15
Steal	15, –5	0, 0

SOURCE: Authors.

possible way for the parties to credibly precommit themselves is to agree to an arrangement outside the game that changes its payoffs and therefore the incentive structure. A collateral is one way to change the payoffs. The collateral of the utility value, set at 8 for example, will make the option to steal unattractive because the payoff for stealing (15) minus the value of the collateral (8) is less than the payoff for trading. The equilibrium of the game will therefore be 10,10.

Another possibility is to introduce a third party that can be committed to imposing a penalty. Both parties would also agree on the rule of imposing a penalty for stealing valued at 8—in other words, an amount that exceeds the private incentive to cheat.[6] The third party would have to be fully equipped to exercise the penalty. In addition, the third party has to have an incentive to impose the penalty on the cheating party. If both parties believe in the credibility of the sanction, the mutually beneficial result (10,10) is the equilibrium of the game.

The institution of this third party is the starting point for the emergence of a state. Having a state as a third party to contracts greatly enhances the range and scope of contracting possibilities and therefore increases gains from trade. How these gains translate into growth will be shown in the following section. The primary function of the state is thus to be an impartial third party to contracts that secures the enforcement of agreed-upon terms.[7]

We have already mentioned that there is another side to this coin: the problem of committing the state to exercise its duty and nothing else. This situation has been labeled a "principal-agent" relationship.[8] The principal is the people, who delegate the task of enforcing contracts to the agent, the state. On the one hand, in order to exercise its function as a third party to contracts, the state has to be equipped with powerful enforcement and control mechanisms, such as a police force or an army. On the other hand, this monopoly of power can also be abused. Establishing an optimal social contract thus involves binding the state to use its monopoly in the exercise of power in the interest of its constituencies.

So this marks a critical trade-off. A society has a need for a powerful state in order to be able to contract efficiently and realize the gains from trade. The society will therefore be willing to give some power to this third party in exchange for the enforcement of contracts: this is what we call the social contract. The emergence of this powerful third party, however, poses the problem of controlling or limiting its reach.

It is our central hypothesis regarding Latin American countries that the state uses this power in a discretionary way. And this causes "bad" institutional uncertainty instead of "good" contracting efficiency.

In the following sections we will address the questions of institutional uncertainty conceptually by exposing the links between the overall growth rate and the institutional framework, especially the political and legal systems. Next we will explore the causes of institutional uncertainty, how it is created and sustained, how it hampers growth and development, and, finally, how it can be attacked by reforms.

The Latin American Disease: Institutional Uncertainty

In 1985, Bolivia implemented an orthodox stabilization program by calling in a famous Harvard professor at a time when most of its neighbors were still tinkering with heterodox programs. Its success in bringing down inflation has received much acclaim, and the mechanics have been copied elsewhere, such as in Poland. Bolivia has done everything right, hasn't it? But growth has not really recovered during the past five years. Real interest rates remain very high, and investment has not picked up, reflecting the uncertainty that investors still perceive.[9] This is what makes Bolivia such an interesting case. It shows the problems that many Latin American countries may soon be facing. The challenge for the 1990s is to move from stabilization to growth. In other words, how can countries stimulate investment and bring back the massive holdings of flight capital? How can the confidence of both foreign investors and domestic entrepreneurs be regained?

Institutional uncertainty as a central cause. Our key hypothesis is that traditional economic explanations and cures severely underestimate the role of the institutional uncertainty that dominates almost all economic decision making in Latin America. Any future-oriented decision, especially to invest in capital (human and real) or in technological progress, involves risks or uncertainty. In point of fact these economic risks with regard to future prices, costs, tastes, and technologies are the deeper cause for the supremacy of the market system over any type of planning. The market is more efficient at solving the information problems on the one hand and at allocating the remaining uncertainty on the other. These economic risks are inescapable and normal for investments in market economies.

When we talk of institutional risks, we have something quite different in mind—namely, the uncertainty on the part of economic actors caused by malfunctioning rules in general and by the unlimited discretion of the government to change almost any rule at any time for any reason. Such institutional risks are a deadweight burden on the economy, reducing investment and limiting the spread effects of this remaining investment. Since this type of uncertainty is deeply entrenched in the entire legal system, it affects everyone, from the man in the street to the members of the national elites. Of course the reaction of the former is quite different from the actions of the latter. These institutional uncertainties are the main focus of our analysis. They lead to substantially higher unpredictability for economic agents and to substantially lower levels of investment. Many economically sound investments remain unrealized because the aggregated risks (economic and political-institutional) are too high. In extreme cases, institutional uncertainty can make any investment prohibitive.

We define institutional uncertainty as the risks arising from a highly volatile institutional environment. Instiutional uncertainty reflects the permanent danger of expropriation or limitation of property rights. Institutional uncertainty means that there are no clear and irrevocable rules of the game

Some aspects of this type of risk are regulation of prices or capital mobility, surprise inflation taxing, unpredictable exchange rate and interest rate manipulations, inconsistent enforcement of contracts, an unpredictable judiciary, discontinuities in the legal system, and finally, outright corruption.

How does this interpretation of the Latin American disease differ from traditional views? Traditional cures, mainly the mainstream school, have concentrated on the contents of policies: they have recommended fiscal discipline, tax reforms, and exchange rate devaluations as means of coping with macroeconomic instabilities. Furthermore privatization, deregulation, and financial and trade liberalization form part of what has been called the Washington consensus on policy reform.[10] Materially, we agree to a large extent with this Washington consensus, but we would postulate that these policy reforms will not be able to generate growth fast enough for the needs of democratic governments, which stand to lose elections if success is not forthcoming. The even bigger danger, however, is that such measures could increase government discretion or rent seeking if the institutional setting remains the same.

This is, in our view, the main lesson to be learned from the findings of Hernando de Soto, as well as from the case studies summarized in Brugger 1991: the uncertainty associated with economic decision making is omnipresent and is the main reason for low investment and slow growth.

Let us look at de Soto's empirical studies of the informal sector in Peru. The enormous transaction costs that informals incur when dealing with the bureaucracy are by now well known (de Soto 1987). *El Otro Sendero* has often been interpreted as simply denouncing the inefficiencies of government and bureaucracies, which drive entrepreneurs into marginalization in the informal sector. This is certainly an important conclusion.

There is, however, another dimension of the studies that we would like to put at center stage: the uncertainty that is involved for the individual decision maker. The problem is thus not only the difficulty of passing through all the prescribed bureaucratic steps and of paying the necessary bribes, but it is also the difficulty of calculating the resources this procedure requires. Case studies confirm this point: they all find that the legal rules are so complicated, contradictory, and unpredictable that it becomes enormously difficult for an entrepreneur to make decisions (Brugger 1991). Of course the uncertainty that surrounds this legal system does not affect all investors to the same degree. Smaller agents are at a natural disadvantage compared with large firms, who are often part and parcel of the "power cartel."

This uncertainty alone has effects as serious as the ones implied by the fact that the costs of access are high. Looking only at the static transaction cost, one underestimates the high degree of uncertainty that surrounds the whole process. Ex post we can only detect the cost in time and money spent on an investment project. But ex ante the uncertainty about these have a meaning of their own.

The findings of de Soto (1987) have been confirmed in several other Latin American countries. Case studies commissioned in Guatemala, Chile, Ecuador, Colombia, and Bolivia confirm the hypothesis that uncertainty with regard to state interventions and enforcement of rules is a major obstacle to development (Brugger 1991). The smaller the entrepreneur, the more he will be affected by this kind of uncertainty. The informal sector can be seen as an extreme case, but a great deal of informality can also be found in the so-called formal sector. In the light of the new case studies, the critique that de Soto's findings in Peru portray a special case is beside the point.

Forms of institutional uncertainty. At the level of the economic agents, institutional uncertainty manifests itself in two different forms:

1. unpredictability of government intervention

2. lack of consistent enforcement of private contracts

The first form of uncertainty concerns the relationship between the state and the private sector. It stems from the discretionary power of the state, which renders the institutional environment of private decision makers so volatile. The second form of uncertainty arises because the state neglects its function as third party to private contracts. This second form, although it also originates within the state, concerns the relationship of individuals within the private sector. This kind of uncertainty affects the range and scope of contracting.

Examples of the two distinct forms of institutional uncertainty will clarify our point.

Unpredictability of government intervention. We have previously cited Bolivia as the showcase of stabilization and mentioned that it is precisely here that the big problem of the 1990s will show up: how to go from stabilization to growth.[11]

The paradox is that the government of Bolivia seems well aware of the importance of reducing uncertainty in order to give sufficient incentives for investment to pick up. From the very beginning the Bolivian government stressed its determination to stay on the difficult route of stabilization.[12]

The paradox arises from the way in which the government tried to establish its credibility: The dramatic reforms that led the country from hyperinflation into monetary stability were implemented by presidential decree (the famous Decreto Supremo No. 21060). Having understood that investment is the engine of growth, the Bolivian government has issued another decree (No. 22407). In this decree chapter IV is devoted to a *regimen de garantia de las inversiones,* guaranteeing the property rights of national and foreign investors. The problem is that this guarantee obviously relies only on the benevolence of the executive. If these rights can be implemented simply by writing a decree, it will also be possible to suspend them with the stroke of a pen. The fact that a powerful executive issues a law does not give the investor the certainty that it is going to be enforced, as this same executive or some other that steps into his shoes will be able to crush it again, without having to respect any institutional safeguards. Credibility cannot be installed by decree! On the contrary, there is hardly anything as detrimental to credibility as the uncontrolled discretionary power of a bureaucracy to issue decrees whenever it pleases.

The Bolivian case is a good example of institutional uncertainty because of the ever-present possibility of state intervention in the economy.[13] The uncertainty about possible regulation of prices, exchange rates, wages, taxes, and interest rates is no different from the uncertainty described in the example: they all lead potential investors to keep their assets liquid (or outside the country). A mere declaration does not overcome institutional uncertainty. Investors need a credible commitment through predetermined safeguards.

Lack of enforcement of private contracts. The second form of institutional uncertainty does not arise from direct state intervention but from another form of discretion, namely the lack of constant and consistent enforcement of private contracts. The jungle of laws so typical in Latin American countries gives the judiciary a priori great potential for discretion. Corruption in this sector seems to be notorious. The resulting uncertainty severely restricts the possibilities of contracting on an anonymous market.

Let us take the example of a credit contract. A credit contract is an intertemporal contract that requires an enforcement mechanism in order to give the receiving party an incentive to pay the loan back. A bankruptcy law is such a mechanism. Obviously, in the informal sector bankruptcy cannot be enforced. The consequence is that loans will only be given by persons that have alternative enforcement mechanisms (such as family members) or else they will be given at a very high cost.

Of course this kind of uncertainty affects different actors differently. Especially for those that have no personal relationship with anyone in the courts and are geographically far from them, the uncertainty alone may be a sufficient barrier to access to justice. On the other hand, there are individuals that have ready access and can influence court decisions easily. But in our view the potential discretion of the judiciary and of those bodies responsible for carrying out the verdicts imposes a negative influence on the society at large. Again, what de Soto (1987) found in the informal sector is the extreme case, but a certain degree of informality can be found everywhere, so that we would go as far as to say there is no formal sector in Latin America.

Negative effects on individual behavior. Institutional uncertainty of the kind discussed above has a direct influence on the behavior of individual actors. To act rationally, households and firms have to respect these uncertainties as constraints on their individual optimization. Uncertain rules and shaky enforcement bias their decisions in two fundamental ways:

1. Too little interpersonal exchange implies a retreat to personal transactions with "private" enforcement mechanisms.

2. Too little intertemporal exchange implies very short time horizons and strong preferences for present consumption instead of investment.

Combined, these two effects reduce individual investment in impersonal specialization and, as we will argue in more detail, significantly hamper the growth rate of Latin American countries.

Too little interpersonal exchange. Missing or uncertain state enforcement mechanisms force individual actors to look for alternative forms of certainty. Because they see the potential gains from specialization and exchange, individuals in Latin American countries have developed their own special forms of enforcement. This is the origin of the informal world that de Soto observed and analyzed in Peru: people who retire from formal enforcement of the state and develop personal institutions. A common feature of all the different forms of informality is that exchange on an impersonal market is replaced by exchange on the basis of personal relations. The number of potential transaction partners is significantly reduced; the result is fewer interpersonal exchanges.

We can distinguish three categories of alternative enforcement mechanisms for, for example, a loan contract. First, a pledge can complement the intertemporal exchange with a simultaneous one. The pledge sets the incentive for the debtor to pay back in the second period. This enforcement mechanism functions only if the value of the pledge is at least as high as the amount that the debtor has to pay back. This condition restricts this possibility to contracts with rather small amounts.

Second, for higher amounts, liability with real assets would be the proper proceeding. But this form fails because of a lack of protected property rights. Nevertheless, this form exists, but with the very costly threat of physical violence as the enforcement mechanism. This threat does not have to be expressed explicitly; the debtor knows that not paying back will mean kidnapping of a member of the family or some other form of violence.

The third mechanism can be summarized as reputation. In a social environment with close personal contact, information about every individual is very precise. There exist mechanisms that cannot work in an impersonal market. One default will lead to exclusion from further contracts because information spreads very well in personalized economies.

This short list of possible alternative enforcement mechanisms shows one thing clearly: exchange is characterized by various forms of personal contact. The number of possible transaction partners is strictly limited, especially in comparison with an anonymous market that is enforced by a state with a monopoly of power. The need to know the exchange partners personally means high transaction costs. The result is that the economy stays at the inefficient degree of specialization of small communities.

Too little intertemporal exchange. We showed above how private enforcement can reduce the uncertainties of contracting for private individuals. Even with these mechanisms, however, uncertainty is not banished. The existence of informal networks cannot, after all, prevent the state from unanticipated interventions in private transactions. The main responses of individuals are to shorten the time horizon in exchange or to minimize the number of intertemporal transactions. Intertemporal exchange always implies buying an uncertain "tomorrow" for a certain "today." The decision to invest, be it in a new machine or in education, has to be based on some idea about what the future will bring. In other words, the potential investor has to form expectations. He will compare the costs of an investment with the discounted value of future returns.[14] These calculations must take into consideration economic risks, such as fluctuations in demand or prices of inputs in different markets. But in our case, the investment also has to respect the institutional risks that arise from the discretionary power of the state. These additional risks are a significant hindrance and choke off many economically sound investment projects. An investment will be attempted only if the return exceeds capital costs by a significant risk bonus. Of special importance are those investments in real or human capital that are specific—that is, cannot be used for other purposes. Such an investment contains a considerable portion of sunk costs. Unhappily, more efficient specialization often means investing in exactly this kind of "asset-specific" project; but it is precisely these projects that are extremely sensitive to risks of every kind.

Instead of investing today, people in countries with high institutional risks would rather wait for tomorrow and prefer to invest abroad.[15] Large-scale capital flight can be interpreted as capital safely parked in foreign (that is, institutionally certain) countries to wait for better times at home. If this hope vanishes too, the owner will follow the capital and emigrate (if he can). The consequence of all this is clear: intertemporal exchange, especially investment today, although economically efficient, will remain the exception. Individual actors will instead attempt to exchange simultaneously. They will try not to make binding commitments with their resources but rather to stay as liquid as possible.

Consequences for growth. The effects of institutional uncertainty that we have described draw a stylized picture of today's Latin American economies. The countries are divided into different networks based on personal relations; within these networks exchange is intensive, but between them economic relations are almost nonexistent. This separation is the consequence of too few interpersonal exchanges, because the state does not efficiently enforce the exchange on impersonal, or anonymous, markets. This is the first broad category of inefficiency. The second inefficiency arises from the short time horizons of individual actors because of the uncertainties regarding future institutional settings. As a consequence, intertemporal exchange is too small. Investment is significantly restricted because investors must get very high returns in order to be compensated for the high institutional risks.

These two inefficiencies taken together lead to economies with a suboptimal degree of specialization and consequently too little growth, compared with a situation of institutional certainty.

The growth costs of institutional uncertainty. If institutional certainty could be established in Latin American countries, it would have two interrelated effects: first, the elimination of institutional risks would significantly stimulate investment, and second, this investment could lead to economywide specialization. In our terminology of the last paragraph, institutional certainty would enhance intertemporal exchange and lead to increased interpersonal exchange. In other words, institutional certainty would not only increase market size but also stimulate the process that is necessary to take advantage of this larger size.

The effects of an enlargement of markets on welfare and growth is one of the central cornerstones of economic research in Europe today. The reason for this is the new dynamism of the European Community, which plans to build a common market under the heading EC 92. In short, European markets will become much larger, because twelve formerly relatively separate countries will form one unified market by 1992. The analogy to our question is obvious. Within Latin American countries institutional certainty would unify formerly separated markets—namely the personal networks—into one national economy. Economically, the effects would be similar to those arising from European integration.

EC 92 has its theoretical base in a broad research program entitled "The Costs of Non-Europe" (Cecchini Report).[16] This study attempted to work out the basic effects of increased market size and to quantify the possible gains. We will briefly describe these effects in three categories below. But the Cecchini Report calculated only the so-called static, or once-and-for-all, effects of market enlargement. New developments in neoclassical growth theory argue that such static analysis seriously underestimates the potential welfare gains. The newest studies show that the increased market size will also affect the growth rate through positive externalities. We will also describe below why we think these dynamic effects are especially important for Latin America.

Static welfare effects of market size. The static welfare gains can be subdivided into three broad effects: better allocation, economies of scale, and increased competition. A larger economy leads first to better allocation of resources through more specialization and more efficient production. The larger the number of transaction partners, the more the individual can specialize to his comparative advantage. In a completely specialized economy everyone can do the thing he does best and obtain all other goods and services on impersonal markets. The effect would be significant if Latin American countries could abolish the inefficient degree of specialization that predominates if contracting is possible only within networks of personal relationships or within rural communities.

A second source of higher welfare are economies of large numbers, if fixed outlays lead to decreasing average costs for bigger production lots. These scale economies can arise in many activities, especially production, research, marketing, management, and financing. This effect can be very important for Latin American countries if fixed initial investment outlays suddenly break even in bigger markets.

A third advantage of larger markets stems from increased competition if monopolistic inefficiencies are challenged by new competitors. This effect would certainly come into play if the relatively closed networks of personal relationships in Latin American countries open up. More competition leads to two favorable developments. First, and for our purpose potentially very important, the new challengers work toward the elimination of monopolistic rents and establish the law of one price throughout the whole country. The special enforcement mechanisms we have described are the ideal breeding ground for monopolistic rents. The building up of personal relations is such a costly activity that it is quite difficult to challenge. This creates a strategic position, because the transaction partner knows that a slight price change will not lead customers or clients to shift immediately to other transaction partners, as it would in a competitive market. Second, the former monopolists lose their safe haven of high rents and have to eliminate internal inefficiencies.

Dynamic growth effects of market size. Potentially more important than the static welfare effects of market size are the dynamic growth effects. The difference in the expressions—in the first case welfare, in the second growth—is intentional. Static gains theoretically change only the level of GDP.[17] Even if these once-and-for-all welfare effects are large in the observed countries, they can be dwarfed by potential dynamic growth effects.

The key to understanding these growth effects is the notion of "positive externalities."[18] Such externalities are created if new knowledge arises because of technological progress.

If a firm improves a production process through research and development or simply through learning by doing, it cannot completely prevent other firms from imitating or using for free at least parts of the new knowledge. But for the imitating firm, this new knowledge is an externality, because it did not have to sacrifice resources for its development. New growth theory builds neoclassical models around this general idea and generates the basic result that the external effects of knowledge are fundamental for understanding growth. That such effects may be very important follows from the general nature of the good "knowledge." To create the first item of, say, a new design for a product is very costly, but all subsequent uses of this design generate almost no additional costs. In other words, such knowledge goods can be accumulated on a per capita basis literally ad infinitum.

The importance of this growth source for our discussion here becomes clear immediately if one defines externalities: externalities are in general the effects of one individual's action on the situation of another individual, effects that are not intentionally traded on a market, that is, are not internalized. Even in this broad definition one feature is obvious: externalities arise if individuals are in contact; the larger the number of interpersonal transactions and transaction partners, the more intense will be this spillover of externalities. More institutional certainty will significantly enlarge the potential number of such transactions, so that externalities will spread much faster and more efficiently. The better the transaction system (the lower the transaction costs), the more positive externalities we can expect from a given unit of investment or innovation. This could be the most important effect of an enlargement of national markets in the Latin American countries observed And this importance is reinforced by the positive effects of competition on the incentives to innovate. Dynamic gains arise from the fact that the harsher competition in a larger market forces the firms to innovate intensively if they want to stay in the market. We again observe a double positive effect of more institutional certainty. First, the rate of innovation is increased, and second, the larger market enhances the diffusion process of the positive externalities generated by these very innovations. A decrease in institutional uncertainty entails a speeding up of such social learning.

Causes of Institutional Uncertainty in Latin America

As a basis for reform, we must now ask what the causes of institutional uncertainty are. The answer is clear-cut: lack of control over the power of the executive because of a malfunctioning system of checks and balances and therefore excessive rent seeking.

The problem of credibility. Earlier we discussed the case of Bolivia. In order to make the transition from stability to growth, the Bolivian government issued a revolutionary decree. This decree seemed to come directly from a mainstream textbook of successful preconditions for growth. Surprisingly, however, the intended investment boom failed to materialize—a very disillusioning result for an ambitious and well-meaning government. Outcomes like this make the idea of special development theories very appealing. But such a quick-fix analysis misses the deeper cause of the problem: lack of credibility. The potential investors in Bolivia acted completely rationally, even in a strictly neoclassical sense. Signing a piece of paper does not eliminate the deeper institutional problems of a country; this point becomes clear if one takes even a casual look at the very impressive constitutions of Latin American countries. The institutional cause for the disappointing result was that investors knew that the same government or maybe the next would be able to change this decree whenever and however it liked. The government or, more generally, the executive has more or less unmonitored power. Individuals retreat into informal personal relation networks because they want to minimize the influence of this potential source of sudden change. Even the best growth-enhancing programs have this self-destructive feature. They can be credible for intertemporal contracts—that is, investment—only if government can be efficiently prevented from changing them.

Sachs and Morales conclude in their analysis of the Bolivian case: "Bolivia now needs a generation of social peace to bring forth the investments that can produce economic growth" (Sachs and Morales 1989: 44). We think that this view is too deterministic and seems to count on a manna-from-heaven effect in the long run. Social peace (which we interpret here as social consensus) is important, as we will argue later. But to reach results in the short run and for today's generation, our analysis suggests an alternative.

Why do institutional settings in Western democracies produce credible results? The reason is that actions of the executive are controlled by a system of checks and balances. This feature of immediate contestability of governmental action is not present in Latin American countries. We believe, therefore, that institutional control of the executive could be the decisive step toward establishing credibility and getting on the way from stabilization to growth.

Lack of checks and balances. The main cause of institutional uncertainty in Latin American countries is that checks and balances are not present. Instead of three balancing powers, the typical Latin American country has a very powerful executive that can change laws and enforcement at will. No judiciary will monitor and no legislature, neither parliament nor voters, can efficiently protest against this discretionary power. The executive can do virtually whatever it likes, and the only reaction of the people is to try to escape by submerging themselves in the informal sector or leaving the country.

We have already established that institutions producing uncertainty do not accomplish the functions for which they were formally intended. In our context, we are interested in the functions of the state to provide security for interpersonal and intertemporal contracting. Ideally, the institutions should be designed to promote prosperity by providing a stable framework within which individual agents can make interpersonal and intertemporal contracts, that is, within which they can trade, save, and invest.

The puzzling fact is that, on paper, Latin American institutions do not differ much from their European and North American counterparts. But there is a big discrepancy between the design of the legal framework and the practice of everyday life. In order to find the reasons for institutional uncertainty, therefore, we have to look at how the institutions work.

Theoretically, a democracy is a mechanism designed to bind the rulers to the will of the people by giving the people the right to elect somebody else. In Latin America, however, democracy does little to limit the discretionary power of the state.[19] A constitution is a form of social pact designed to bind the government to a long-term agreement. In Latin America constitutions do not represent this long-term social contract: since their independence the Latin American countries have altogether promulgated 255 new constitutions (Rosen 1984: 8)!

Ideally the parliament should be the forum where rule setting takes place, in a legal process that guarantees that the rule setting reflects the needs and wishes of society. In reality, parliaments in many Latin American countries are very weak. It is common for the executive to invoke the state of emergency and seize the power to issue executive decrees. This circumvention of parliament weakens the position of the legislative body and also produces duplicate and contradictory laws. It therefore becomes increasingly difficult for anybody to be sure which norms are still valid. Against this background, it is not surprising that the courts add to institutional uncertainty, rather than reduce it.

The role of the judiciary should consist in providing impartial and independent resolutions of disputes and therefore the enforcement of rules. The reality is rather different: access to courts is expensive, proceedings are time-consuming, decisions are unpredictable, and corruption is widespread. The fact that the legislature and the executive produce a multitude of laws makes it almost impossible for anyone to know which ones are actually in force. This uncertainty makes the courts the ideal place for bargaining, corruption, and rent seeking. If courts fail to execute their function as countervailing power to the legislature and executive, they make a major contribution to the uncertainty about rules and enforcement of rules.

Rule of law is replaced by the discretionary power of the executive. By executive power, we mean both the executive and the bureaucracy. We have already mentioned that many governments have declared a national emergency and have, therewith, taken over the power to issue presidential decrees. This corresponds to a de facto suspension of the democratic process and gives the executive an enormous amount of discretionary power. This discretionary power is the main reason for institutional uncertainty.

Breeding grounds for rent-seeking activities. In the preceding section, we may have created the impression that the main problem lies in a sort of autonomous power of the state. This does not seem to fit Latin American reality. Strong links between parts of the private sector and the state seem to be the rule, not the exception. We have already mentioned that a climate of institutional uncertainty is the breeding ground for a rent-seeking society.[20] Of course, this applies not only to those persons that actually compose the executive and the bureaucracy, but also to those pressure groups in the private sector and the elites that are in a position to seek political rents. In this sense institutional uncertainty and rent seeking form a vicious circle because they drive each other on. The losers from this constellation are, in the first place, those who are excluded from rent-seeking possibilities (usually those that are not close to the government in geographic and personal terms).[21] It is clear, however, that a rent-seeking society is fighting for redistribution of a constant or even shrinking national product. For this reason, in the longer term all members of this society will be losers compared with societies that were able to limit rent seeking.

Government is not nearly so omnipotent as the description of the power of the executive may have suggested. On the contrary, in most instances government is remarkably weak. For example, almost no government seems able to collect income taxes. Either there are strong pressure groups that succeed in getting tax exemptions or the bureaucracy is unable or unwilling to collect the taxes. The bureaucracy benefits from the disorder and confusion arising from the dysfunction of the other institutions. Bureaucrats reap a lot of discretionary power, which they can use for rent-seeking purposes. A bureaucrat can choose the speed of processing or even the kind of law he is going to apply to a certain case according to the level of bribes he receives. The bureaucracy develops a dynamism of its own that the government cannot control. This again forces the government to resort to tariffs or inflationary financing of its expenditures.

So the large but weak state with no binding limitations and no clear principles guiding its interventions allows powerful minorities to be favored through the political system, at the expense of the large and usually poorer majority. This majority is uninformed in Latin America and politically powerless to fight the cartels of the national elites. The leadership in both government and interest groups exchange information and money in order to extract political favors or to promote members of the group to important political offices.

Lack of constitutional consensus and the role of ideologies. Having demonstrated the basic problem of the Latin American disease and its effects on welfare and growth, we now want to discuss the social causes of this situation. Steps toward reform, according to our findings, must concentrate on credibility of governmental action and therefore on mechanisms of checks and balances. But before talking about such steps it may be interesting to say a few words about the basic social causes of these malfunctioning institutions.

Institutions function best when a large majority thinks that these rules of the game are just and that they establish fair conditions. In other words, broadly based social consensus is the best foundation for a well-functioning society. But it is precisely this feature that is absent in Latin American countries. Not social consensus but social conflicts dominate these societies. Such conflicts can be based on region, race, class, sector, or other factors. The most important of these possible conflicts for Latin America seems to be the extremely unequal distribution of income. Sachs (1989) considers this problem to be the primary source of social conflict in Latin America. The central hypothesis of his paper is that large inequalities in income build up intense political pressure on macroeconomic policies to raise the income of lower-income groups, which in turn contributes to bad policy choices and weak economic performance. It is especially interesting that he explains the phenomenon of populism as resulting from conflicts that reflect the extreme inequality of incomes.

This point demonstrates clearly the consequences of institutions that lack social consensus. The poor realize that they have very few possibilities of influencing and controlling the institutions. The powerlessness of the people over everyday government activities is most often covered up by the executive behind seemingly attractive populist measures. At this point the role of superficial ideologies in the political process sets in. The less political legitimacy is based on efficiency and functional institutions, the more the political elites will have to invest in ideology and charisma in order to convince the people of the fairness and justice of the existing arrangements. To invest in ideology as well as nationalism is also often a cheap way for the above-mentioned rent-seeking elites to build up a barrier against the tide of popular discontent.

To break up this combination of powerful elites and the powerless but ideologically dazzled masses that leads to the discretionary use of institutions, it will be necessary to establish control mechanisms.

Institutional Reform

The Homeric account of Ulysses and the Sirens has a great deal of explanatory power for what follows in this section. According to the saga, Ulysses correctly anticipated that he would not, any more than any other man, be able to resist the tempting songs of the Sirens. He was nevertheless able to "subvert certain inclinations of his future self" by binding his hands to the mast of his ship (Brennan and Kliemt 1990: 125).[22] It may be that this Homeric account is the basis for the notion of having one's hands tied. The idea is to precommit oneself credibly to a certain future choice. The problem of credibility is obviously solved only if the alternative option is no longer present at the relevant moment—when temptation comes.

We may be stretching the metaphor a little too far, but the central idea of institutional reform is, in our view, to design institutions that accomplish this tying of hands.

Blackboard economics and institutional reform. On the surface, making reform proposals may seem rather easy, especially if it is done in the traditional way, which Coase (1988) aptly labeled "blackboard economics." We formulate a model of an ideal economic system and then, comparing it with what we observe (or claim to observe), we prescribe what is necessary to achieve the ideal state. "The analysis is done with great ingenuity but it floats in the air" (Coase 1988: 28). In the language of the Ulysses tale, blackboard economics would entail showing why it is bad to follow the temptation of the Sirens and concluding that the temptation should be resisted. It would not mention the rule that enables the tempted to resist temptation. In point of fact, economic policy involves a choice among alternative institutional arrangements. Economic policy that really matters is a change in the rules of the game.

We therefore formulate our reforms, not along the lines chosen by the blackboard economist, but by speculating on how the economic system would work under alternative institutional conditions. The greatest challenge of such an approach originates from the fact that we have left the world of idealized frictionless models. Our proposals should evolve from the given institutional structure. Some measures will have to come from the top downward, others inevitably have to work from the bottom upward. The common goal of all changes is to create a check on the major sources of institutional uncertainty. Since this is mainly excessive discretion, we propose to make political power contestable by all available means.

Conceptual framework for reform. The problem of the social contract is not so different from the problem facing two private individuals making a contract. We have explained it in detail: there is a need for a third party that ensures that the commitments are honored. If the problem of a private contract can be solved by introducing a third party, why should there not be a similar solution to the problem of the social contract? But then shouldn't there be a fourth party to oversee the third party? And a fifth party to oversee the fourth? This route obviously does not take us far, because we enter into an infinite regress, and the problem of who is to control the controllers and how is not solved.

We have been talking a great deal about the state, and it is worth mentioning that there are very different conceptions in economic theory on how the state should be interpreted. One approach takes a very naive view of government and bureaucracy. It assumes that the executive acts as a benevolent dictator, whose only aim is to maximize the welfare of the population. This view seems to have great appeal, especially in Latin America. One problem with the benevolent dictator solution is that it may not be able to overcome institutional uncertainty. This is the case whenever the actions of the dictator are not regarded as lasting. If the dictator can be overthrown the next day, even the best institutional reforms are not credible. Expectations, therefore, will not stabilize and investment in specialization will not increase. This is a very powerful argument against authoritarian regimes, which would fit quite well into the blackboard economist's world view.

A second approach takes the opposite view that benevolent dictators are rare and even those who are benevolent are in danger of being corrupted someday. It argues in an almost cynical way along the lines of public choice theory. The only aim of government in this model is to maximize personal welfare. Efficiency-increasing reforms are realized only if the future revenue of the executive exceeds revenue under the status quo, an unlikely outcome if the main reason for inefficiency is the rent-seeking behavior of government itself. In this extreme model, the only way to achieve reforms is through an exogenous force such as revolution, war, or a "friendly takeover" as in the case of the former East Germany.

Our reform approach is positioned somewhere in between. We do not assume that the vested interests will give up their position of power by insight alone (although we think that ideas and ideologies matter, and the record of Latin America shows that ideas have made a difference). There is little hope in waiting for the benevolent dictator who will be able to resist the Sirens by a mere act of will. There has to be pressure from within and from without.

The goal of the changes we propose is to reduce institutional uncertainty by

1. reducing transacting uncertainties between private actors

2. reducing the potential for unpredictable and unlimited government intervention

The origin of both forms of institutional uncertainty lies in the vicious circle of discretionary power of the executive and rent-seeking activities of interest groups. The goal is therefore to break this circle by limiting the discretionary power of the executive.

In the example of Ulysses, the limitation was introduced in the form of self-constraint. Such self-constraints are quite familiar in everyday life. We leave the car at home to avoid drunken driving after a party. Self-constraints between two contracting parties are more complex, because they require more sophisticated enforcement mechanisms. Unfortunately, the scope of such mutually binding contracts is limited (and therefore restricts the number of potential transaction partners) and leads to the necessity of having a third party as an enforcer and often also as a producer of rules—and with this we fall back into the trap of infinite regress. There is no ideal way to solve this basic paradox of democratic rule.

We therefore have to look for alternative mechanisms that introduce the necessary constraints. We focus our conceptual framework covering all these constraints on "political contestability." Contestability means that there is a set of institutions that ensure competition within the state and competition from outside the state.

Perhaps contestability is best described in the domain of the market.[23] A contestable market is one where access or entry is possible, with the result that the actions of the firms in the market are constrained by the potential entry of new firms. As soon as the "insiders" try to reap too large a rent (through monopoly or oligopoly), the entry of new competitors erodes their discretionary power. In the political process contestability ensures that the potential rents from the discretionary power of the executive are competed away in a similar manner.

In other words, we want to play a "better game"—not by demanding better players but by instituting better rules. And better rules means megarules that guarantee the stability of rules.

There are two main avenues toward this goal:

1. *Internal constraints.* These include all rules breaking up power within the country either by giving more power to the individual (in other words, enlarging the domain of individual property rights) or by dividing power within the

different government agencies (for example, decentralization and federalism).

2. *External constraints.* These are based on the principle of tying one's hands by giving away some national sovereignty. The fact that power on certain issues is delegated to supranational bodies creates the necessary credibility that the power is not going to be abused. The other form of external constraint is the increased role of external conditionality in connection with international transfers or other forms of support.

In our opinion there should be a combination of external and internal reform proposals in order to stimulate as much reinforcing interaction between them as possible.

Internal constraints. Internal constraints have to evolve within the given government structure. Of course, such reforms may involve a long and difficult process, because political elites cannot be expected to give up their discretionary power voluntarily by imposing self-constraining measures on themselves. The kind of constraints we envisage are rules that limit the discretionary power of the executive by enlarging the domain of individual rights and creating competition within the state.

Enlarging the domain of individual rights. These reforms aim at increasing contestability by giving individuals the institutional mechanisms to challenge the law-making and administrative powers of government. This is more or less the path taken by de Soto and his team (de Soto 1987). It is obviously not easy, and success may set in slowly because it involves a process of structural change in society. Through information and mobilization of political groups that belong to the traditional losers of the current system, pressure from below is gradually built up. The aim is to build a constituency whose interests run counter to the vested interests. In Peru the informal sector may prove to be such a constituency.[24]

The success of Peru's Institute for Liberty and Democracy (ILD) shows that governments are not in a position to ignore strong movements from below.[25] Of course, the rent-seeking interests and the power-grabbing elites do not vanish by insight and experience alone. Nevertheless, exposure of the winners from self-serving regulation and protection is a powerful weapon of the majority. The provision of information is one key to the mobilization of new political classes, which have traditionally been on the losers side. Competent and independent mass media are important instruments through which rent seeking can be attacked. Sen (1984) contends that the relatively free and outspoken press of India is instrumental in avoiding mass starvation. Exposing the distributional or allocative consequences of inefficient government policies also helps in Western democracies. The big advantage of the media is that it can mobilize the masses against privileges of powerful minorities.

Information and formation of strategic pressure groups are necessary but not sufficient conditions for the imposition of internal constraints. The provision of institutionalized mechanisms of communication, access, and control are just as important. Such institutions should increase the rights of the individual vis-à-vis the state and promote competition within the state.

Creating competition within the state. There are basically three broad categories of measures in this field. First are direct democracy elements. Direct democracy is one way to increase the power of the individual economic actor over the discretionary behavior of the state. The formation of the Swiss state, with its heterogeneous regions and cultures, would be unthinkable without the installation of strong individual rights combined with extensive federalism and decentralized government. In fact, the ILD is proposing certain principles of direct democracy for Peru as one feedback mechanism that limits the discretionary power of the government (ILD 1990b: 4; ILD 1990a).

Second, competitive federalism and decentralization can help stimulate competition within the state. The basic idea here is to divide executive power between the national and regional levels. This will make government more accountable not only by bringing agencies and bureaucracies closer to the people but also by introducing competition between different regional and local governments. Competitive federalism can be viewed as an innovation-generating institutional setup. In the extreme, one could foresee the right of regions to secede from other regions or even the nation. We will meet this basic idea again when we talk about supranational constraints in the next section. To create competition between regions by decentralization can be an efficient way to create well-functioning institutions. Setting up the best and most stable rules can become a goal for the decentralized regions. The most productive mobile factors of production would go in the region that has the most attractive institutions.

Third, it is important to establish checks and balances. Unmonitored power of the executive is, according to our analysis, the central cause of institutional uncertainty in Latin American countries. The classical political reaction to such a situation is to call for an enlargement of checks and balances. It is obvious that an institutional reinforcement of the two other powers, judiciary and legislative, would be an effective means of cutting back discretionary power. We have shown above that legal uncertainty is especially harmful and is mainly due to the arbitrary and unchecked ability of the executive to govern by decree. This ability should be broken by simple rules, such as automatically phasing out those decrees that are not confirmed by the legislature within a certain period of time.

External constraints. The common feature of external constraints is that they limit the domain of national sovereignty. At first sight, a loss of national sovereignty may seem completely unacceptable. As we explained earlier, a national state apparatus is necessary to guarantee the "rules of the game." But we have also shown that national sovereignty can be vertically divided in a federal system and thereby introduce institutionalized political competition within the state. The idea now is to divide power further on a supranational level.

Why do countries voluntarily join GATT? In every country there are vested interests that lose on free-trade agreements. These pressure groups therefore try to influence the political process in order to conserve their rents. To join GATT means to commit oneself to free trade. The individual government can no longer be held responsible for unpopular measures against structurally weak sectors of the economy, because the blame lies with the supranational body. Thus supranationality may serve as a welcome constraint that provides a credible precommitment to a certain policy direction. Joining international institutions and accepting their rules in the abstract and beforehand is a good way to tie one's hands.

This is the true secret of the European integration success story. France, Italy, and Spain all profited from turning over the determination of the interest rates to the European monetary system (EMS)—in point of fact, to the Deutsche Bundesbank. The commitment to stick to a fixed exchange rate may be interpreted as a loss of national sovereignty. But sovereignty to do what? To abuse their exchange rate discretion? The EMS is an institutional change that will increase the political price of devaluation dramatically. And this arrangement will greatly restrict macroeconomic adventures. Of course, the same thing has long been true for trade policy, where GATT obligations have limited the follies of bureaucracies and the power of interest groups.

The International Monetary Fund (IMF) and the World Bank are other international institutions with great evolutionary potential. The much despised and denounced "conditionality" of international credits could get a new life and become a crucial instrument to limit national abuses. Why should it not be possible to develop rules of conditionality behind the "veil of ignorance" by the recipient countries themselves? Such ex ante rule making would be completely different from the present and past pressures exerted by the IMF after the disaster has struck. If our analysis is not off the mark completely, conditionality would have to extend far beyond macroeconomic blackboard stability. It would have to include institutional reforms.

Conclusions

This essay has argued that overcoming institutional obstacles is a necessary precondition for achieving growth in Latin America. It has been shown that uncertainties about the rules of the game have devastating effects on private investment and specialization. The main cause of the institutional uncertainty that can be observed throughout most of Latin America is the highly discretionary power of the executive, which changes laws at will and enforces existing ones only inconsistently. Instead of being the anchor that provides the necessary stability for interpersonal and intertemporal exchange, the law itself becomes the main source of intransparency and instability. This climate creates the ideal breeding ground for rent seeking by powerful interest groups capable of using the intransparent and unchecked system to their advantage. Reform steps that will really enhance growth, therefore, must establish more institutional certainty. They must limit the discretionary power of the government by introducing constraints from within and from without.

The question remains whether there is any chance that this kind of institutional reform will take place. Is there any hope that Latin America will move in the direction we describe? Where could the impetus for reform come from? This last question is really the crucial one. Can we reasonably expect a powerful executive to voluntarily limit its power and divide it up among many competing entities? Of course, there have always been leaders farsighted enough to see the advantages of binding their own hands—that is, of introducing democratic constraints and checks and balances that will limit their own scope of decision making. Like Ulysses, they themselves might benefit from this strategy. But they are not likely to in a system that is inherently shortsighted and where overthrows are always a danger looming on the horizon. Although there seem to be promising signs—like the constitutional reform in Colombia—we do not believe that this will be the path to institutional reform in Latin America.

If we discard the possibility that governments might be benevolent and farsighted enough to start the reforms themselves, are there other quarters from which the pressure for reform could come? One other internal constraint that we mentioned is the pressure that opposition groups put on governments. The guerrilla threat belongs to the past and no longer poses any serious danger to most Latin American governments. But the growing informal sectors—that is, the growing mass of urban poor, who are systematically excluded from the benefits that some powerful pressure groups enjoy—might exert important leverage for reform. This is the strategy the Institute for Liberty and Democracy in Peru pleads for. We agree that better information and organization of the losers from the present system might be a viable route to reform throughout Latin America.

Our biggest hopes, though, arise from what we call external constraints: the increased pressure from the competition of the Asian newly industrialized countries, the increasing danger of capital flows being deviated from Latin America to Eastern Europe and the former Soviet Union. These are pressures that will pave the way for institutional reform. Mexico may soon be a showcase for successful reform, driven by its integration into a North American free trade zone. As the examples of Spain and Portugal show, integration can be a powerful lever for growth, because it provides a credible commitment for stable, market-oriented, and noninterventionist economic policies that the previous unstable political systems were not able to provide. It may be that the case of Mexico cannot be generalized, because no other country has such a long border with the United States. If this is the case, then external constraints will increasingly have to come from international organizations like the IMF and the World Bank. This is a delicate subject, because such pressure could be perceived as intervention in national sovereignty. On the other hand, the IMF and World Bank are already applying conditionality. We believe that institutional conditionality, in the long run, could produce important gains in economic growth.

NOTES

1. These projects do not all stem from the 1970s. As late as 1986, President Alan García of Peru undertook the construction of an electric railway in the city of Lima. The cost estimates projected US$800 million for thirty-six kilometers. The project was initiated in a hasty and disorderly way. When construction started, detailed technical plans were still missing, and the contractors proceeded on the assumption that an expensive kind of construction would be required. The construction of an elevated train began even before the decision that it would be elevated was made. Today two kilometers of almost finished platforms cut through the squatter towns. See Keefer (1990: 17ff.) for a detailed discussion of this case.

2. The notion of relative attractiveness was studied and explained for the case of Switzerland in Borner et al. (1990).

3. For further definitions and discussions of institutions, see Hechter et al. (1990), Nabil and Nugent (1989), Ruttan and Hayami (1984), or Ostrom et al. (1988).

4. The origin of rules and their evolution is discussed from the perspective of economics in Rowe (1989). A sociological treatment is found in Hechter et al. (1990).

5. Given this incentive structure, it seems impossible to induce cooperation rather than noncooperation. The emergence of cooperation is usually explained in a repeated form of the game. In a repeated prisoner's dilemma one party could, for instance, use a "tit-for-tat" strategy, rewarding cooperation in the last round by cooperating (tit) and punishing defection by defecting (tat) in the following round. The experimental game theory has found that this pattern may provide an incentive for cooperation, at least in the early stages of a repeated game. The main problem for both parties is their inability to credibly precommit themselves to a strategy forever. For instance, if both parties could commit themselves to a tit-for-tat strategy, it would not pay for either of them to steal because they would know that they will forgo the benefit of trading forever: once one of the parties plays "tat," the other has no option but to go on playing tat forever. This could be a mechanism to induce a cooperative solution. The problem arises in the last round: the commitment not to steal in the last round is not credible, because after that round the

relationship (and the potential benefits from it) will be discontinued anyway. By the backward induction argument, the certain defection in the last period will make cooperation impossible in any earlier period. From a theoretical point of view, cooperation cannot be explained in a game with perfect information. Theoretical explanations of cooperative behavior run along the lines of incomplete information, binding rationality, or allowing for an infinite number of repetitions.

6. In general, the amount of the collateral or of the penalty *(P)* has to exceed the incentive to steal. That is, the condition $15 - P < 10$ must hold.

7. Of course the state provides a number of other public goods, but in the approach we take here these are disregarded. Our focus is primarily on the legal and political institutions of a state that exercises its most "primitive" function.

8. A basic reference for the notion of "principal-agent" is Jensen and Meckling (1976).

9. Morales comments that,

> The private sector's low investment rates are conventionally explained by high interest rates, weak markets for traditional exports, and competition from imports (many of them smuggled). But more important than the factors supra are the *credibility problems,* not as to stabilization, but as to long-term developments. Fears of a future reversal of policies still prevail in the private sector. The persistent weakness of the public finances, with equilibria perceived as unstable because they are brought about by lags in the wages of civil servants, may awake fears of future *confiscatory measures to the private sector through exchange rate manipulations, punitive taxes, or outright expropriation* (Morales 1990: 38, our italics).

10. For a good description of what Washington means by policy reform, see Williamson (1990).

11. The same seems to apply to Poland, where tough stabilization runs parallel to weak growth expectations.

12. As Morales comments, "Adherence to the announced stabilization policies, notwithstanding the external adversities, was the landmark of the Paz-Estenssoro government and the most important source of credibility" and further on "Over and over, the government stressed that no money emission would take place, except when it was backed by international reserves" (Morales 1990: 24 and 26).

13. Keefer (1990) calls this uncertainty "No rules for the creation of rules."

14. For ordinary investment decision criteria see Hirshleifer (1987).

15. This is why this phenomenon is called "the waiting option." See Pindyck (1990) and Dornbusch (1990).

16. See the summary in Commission of the European Communities (1988).

17. See, for example, Lucas (1988: 12).

18. For a detailed discussion of this notion and its crucial effects on growth, see Romer (1990).

19. The *ILD News Letter* noted, "Our main conclusion was that every five years, Peruvian citizens elect a dictator" (ILD 1990c: 2).

20. The term "rent-seeking society" was introduced by Krueger (1974).

21. Olson (1982) discusses the growth effects of distributional coalitions.

22. We were inspired with this symbolism by the logo of the journal *Constitutional Political Economy:* a representation of Ulysses bound to the mast of his ship.

23. The term "contestable market" was introduced by Baumol, Panzar, and Willig (1982).

24. Also often on the losers side are the smaller farmers, who suffer from agricultural policies that subsidize the urban consumer to the detriment of the producer. In highly centralized countries like Guatemala, the regions are neglected and could be mobilized. For further discussion and case studies on the question of building constituencies for economic change, see Sullivan (1987).

25. ILD is headed by Hernando de Soto, who published first basic empirical results of this institute's research activities in de Soto (1987).

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