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The Economic Role of Political Institutions

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Thriving markets require not only an appropriately designed economic system, but a secure political foundation that places strong limits on the ability of the state to confiscate wealth. This requires a form of *limited government*, i.e., a state whose institutions credibly commit it to honor economic and political rights. To learn something about how this may be accomplished, this paper studies how limited government arose in states of the developed west. Specifically, it focuses on the critical role of federalism for protecting markets in both England and the United States. Federalism proved fundamental to the impressive economic rise of England in the 18th century and the United States in the 19th and 20th centuries.

The main implication for today is that attention must be paid to the political underpinnings of the economic reform. To this end, the paper compares the reform efforts of China and the former Soviet Union, arguing that the former's success lies in part in its having secured an appropriate political basis for economic reform. In short, a successful market system cannot be built without attention to the form of the constitution and limited government.

The Economic Role of Political Institutions

Barry R. Weingast

Executive Summary

The fundamental political dilemma of an economic system is this: A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens. Thriving markets require not only the appropriate system of property rights and a law of contracts, but a secure political foundation that places strong limits on the ability of the state to confiscate wealth.

This dilemma is readily apparent for the case of economic reform in Eastern Europe and the former Soviet Union. Standard advice of economists focuses on the design of a market system. Although critical to transforming the economic system, this advice is incomplete: It ignores politics and the possibility that political forces might intervene in the future to halt, reverse, or destroy the development of a market system.

Providing for the security of a private market economy requires a set of political institutions that *credibly commit* the state to those markets — i.e., that limit future political discretion with respect to economic decisions. Because the development of a thriving market system requires a considerable range of investment that is vulnerable to political opportunism, fostering these investments requires providing them with adequate protection. This requires that the institutions of public choice be fashioned so that not only may future problems be addressed but that property rights are protected. Devising such a structure provides for the role of the constitution, conceived here as the set of institutions governing political decisionmaking, and, especially, the institutions or rules governing how choices are made among alternative specifications of the economic system.

Credible commitments to markets thus require constitutional limits whose constraints prove binding in practice. To study how constitutions accomplish this, this paper considers how credible commitments were provided in the developed west over the past few centuries. Because many of the key questions facing today's emerging democracies were once faced by the developed western nations, considerable insight can be provided about today's problems by studying similar problems as they arose in the past.

For this purpose, I focus on an important constitutional factor facilitating the economic development of the several Western nations, *market-preserving federalism*. Market-preserving federalism limits the degree to which a political system can encroach upon markets. Moreover, it has played a central role in the economic rise of those nations that have been the richest in the world over the last several centuries: The Dutch Republic in the late 16th and early 17th centuries, England in the 18th century, and the United States since the mid-19th century.

The economic consequences of market-preserving federalism are well-known. It simultaneously induces competition among the lower political jurisdictions while placing restrictions on the economic policymaking of the national government. In England, market-preserving federalism provided the political foundation for the success of the industrial revolution in the north. In the United States, it provided the basis for the common market, fostering first regional and then international specialization and underpinning the great growth in American wealth.

For federalism to have this effect, however, the constitution cannot simply be a "parchment barrier" of written rules. The latter can be changed, avoided or ignored. To survive, federalism requires self-enforcing restrictions, i.e., ones that make it in the interests of national political officials to abide by them.

The main lesson for contemporary problems of economic reform and development is that the benevolent attitude of the government cannot be taken for granted. Markets require protection. It is not simply that policymakers must strongly favor reform and introduce measures to pursue that goal. They must do so in ways that make their reforms durable. Economic reform in the emerging democracies must therefore rely on more than just the desires and dedication of current policymakers.

The paper also compares economic reform in the former Soviet Union and in China, emphasizing the importance of the economic role of political institutions. Strong conclusions cannot as yet be drawn from such a comparison. Nonetheless it is striking to observe not only the enormous difference in the approaches to reform, but in their relative success. The former Soviet Union began by concentrating on its economic system, retaining strong discretionary powers for the government. No attempt was made to establish limited government or to tie the government's hands with respect to future economic policy. Although there has been some attempt to institute political rights and democracy, these components of public decisionmaking have yet to translate to limited government. The Russian government's retention of discretionary authority has two direct implications. First, it may introduce any economic system it wants. Second, it may alter that system at will.

In contrast, China began with political reform in which the central authorities, while not completely binding their hands, made it harder for them to use those hands. The Central Government instituted a set of limits on themselves by giving away power to local authorities in a way that would be difficult — and which recently proved difficult — to retake. This, in turn, set the stage for economic transformations across much of China. Political freedom and political protection from the central state combined with economic opportunities to provide local governments with the incentives to institute market. The economic success of Southern China is nothing less than remarkable.

This suggests that redesigning economic and political institutions should be attempted simultaneously. Though definitive conclusions cannot be made, the historical evidence supports this position. The comparison between China and the former Soviet Union further suggests that limited government appears to be an important component of economic reform. This emphasizes the critical *economic* role for *political* institutions — to provide the appropriate foundations to economic policymaking and a secure system of economic and political rights.

The Economic Role of Political Institutions

Barry R. Weingast*

1. Introduction

The fundamental political dilemma of an economic system is this: A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens. Thriving markets require not only the appropriate system of property rights and a law of contracts, but a secure political foundation that places strong limits on the ability of the state to confiscate wealth. Far from obvious, however, are the circumstances that produce a political system that plays one role instead of the other.

This dilemma is readily apparent for the case of economic reform in Eastern Europe and the former Soviet Union. Economists focus on "getting prices right," i.e., providing for the broad outlines of a market system — flexible prices reflecting scarcity, a system of private property rights, and appropriately structured financial, monetary, and tax systems. Unfortunately, this ignores politics and the possibility that political forces might intervene in the future to halt the development of a market system or redistribute a sufficiently large portion of the wealth thus created. Either course of action holds the potential to destroy a fragile, nascent

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economic system. The fundamental political dilemma forces us to ask what form of political system is required so that a viable, private market economy is a stable policy choice of that political system?[1]

For a large range of problems, the relatively stable market systems of the developed west grant us the luxury of ignoring the possibility of massive political change. Whether studying taxes, monetary policy, or regulation, we can take the market system based on private property rights and the rule of law as given. But being able to take markets as given in the developed west does not imply that they can be taken as given in reforming economies. Market stability in developed nations reflects the very political stability that is missing in the latter.

The absence of an adequate political foundation for markets typically creates a form of *equilibrium trap* that prevents development. For economic actors to undertake costly actions necessary for economic development, they must expect to garner the return of their efforts. The potential redistribution of these returns — whether through a substantial tax increase, a wholesale reversal of the reform process, or outright confiscation — reduces the expected private return to these actions. This implies that an uncertain political commitment to markets creates a form of *political risk* over and above the standard economic risks. Holding the economic characteristics of a given investment constant, the larger the political risk, the lower the expected returns. Because political risk drives a wedge between the private and social returns to economic activity, substantial political risk deters the economic actions needed for economic reform to succeed.

Potential economic development introduces the possibility of political risk for accumulations of wealth. Because sources of wealth have always been tempting for others to tap, development requires political protection of wealth — including protection from politics itself.[2] In the inchoate

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[1] Two recent collections of studies of the transition from socialism to a market economy illustrate the economists' focus, Clague and Rausser (1992) and Murrell (1991). Both emphasize the design of policies implementing a market system. With the exception of the Rausser's concluding essay (in the first) and Litwack's (in the second), none of the studies address the issues raised by the fundamental dilemma of economic reform.

[2] Historically, for example, the sovereign or the state itself has been a major problem in this regard. In early modern Europe, this was typically the sovereign strapped for cash (Schumpeter 1991, North 1981, ch. 11). For many developing nations, the problem is a predatory state.

democracies of Eastern Europe, the problem may well prove to be a "democratic" government facing unexpectedly hard times. To see how the latter might arise, suppose that, in a few years, one of these states experiences hard economic times, including a large debt, the lack of new credit, a dismal economy, food shortages, and a citizenry clamoring for reform *now*. In the face of immediate and pressing problems, the state will be tempted to sacrifice key elements of long-term economic success to mitigate a crisis today (see, e.g., Offe 1991, 886-87). McKinnon (1991) concludes that this temptation will prove too powerful to resist, i.e., that unanticipated revenue shortfalls in the emerging democracies will lead to "unpredictable reinterventions" in order to increase revenue to solve short run problems. Such reinterventions may well halt or dismantle existing reform efforts.

Unfortunately, the problem is even worse than this scenario suggests. The need for immediate revenue during a crisis implies that taxes will be raised or regulatory policies changed in a way that inevitably burdens those firms or sectors of the economy that have been most successful. This in turn has a critical feedback effect. Because the possibility of confiscation during hard times is known in advance, entrepreneurs and potential investors facing this risk will discount the potential returns from their investment by the probability they will be diminished in a future crisis. This results in a clear *disincentive* to promote economic growth in the first place. When these disincentives are sufficiently large, they produce the no-growth equilibrium trap in which a society cannot alter the status quo, despite radical changes in announced policy.

The equilibrium trap demonstrates the intimate relationship between the political and economic systems. They are inextricably intertwined. Yet equilibrium traps of this sort are not inevitable. Indeed, they may be mitigated by creating certain types of institutions. Providing for the security of a private market economy requires a set of political institutions that *credibly commit* the state to those markets — i.e., that provide for limits on the range of future political discretion with respect to economic decisions. This implies that today's economic reform must not only pay attention to the content of today's policy, but to how tomorrow's exercise of political discretion might alter that policy.

To develop the logic of this claim, consider the same set of issues as they arise in the new institutional economics. Much of this scholarship focuses on the problem of opportunism, a form of incentive problem that occurs when the value of a set of assets held by one party depends on actions taken by another.[3] The new institutional economics holds that the firm's organizational structure is designed to mitigate foreseeable contractual problems such as opportunism. Summarizing this logic, Williamson (1985, 48-9) suggests that when transactions are subject to ex post problems, wise bargaining parties will attempt to mitigate these problems ex ante by creating a *governance structure*. That is, they will create a set of arrangements that alter incentives so that carrying out the original bargain — rather than behaving opportunistically ex post — is compatible with the incentives facing the actors after the fact. Contracts of this form are said to be *self-enforcing* and therefore represent a credible commitment.

This same principle applies to the development of political institutions. On the one hand, citizens need a means of dealing with future problems and social challenges as they arise. On the other, a thriving market system requires protection for a considerable range of investments that are vulnerable to political opportunism. These twin tasks of a political system, however, are not fully compatible. Because the success of reform depends upon protecting investments from political change, restrictions must be placed on the political mechanisms designed to accomplish the first task. In terms of the language of the new institutional economics, this requires a form of governance structure fashioned to structure relationships among members of the polity/economy in a way that allows them to address future problems while protecting property rights. This provides for the role of the constitution, conceived here as the set of institutions governing political decisionmaking, that is, the institutions or rules regulating how choices are made among alternative specifications of the economic system. Understanding these relationships requires development of a new *positive theory of constitutionalism* which seeks to explain how constitutional limits work and why some constraints prove binding in practice.

To learn something about how constitutions make credible a commitment to markets, this paper considers how credible commitments were provided in the developing west over the past few centuries. Because many of the key questions facing the emerging democracies of today were

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[3] On the problem of opportunism, see Klein, Crawford, and Alchian (1978), Milgrom and Roberts (1992), and Williamson (1985). More generally, this approach derives from the work of Coase (1937, 1960).

once faced by developed western nations, considerable insight can be provided about today's problems by studying similar problems as they arose at an earlier time. Although today's circumstances differ substantially from those of earlier eras, important lessons about the political foundations of markets can still be learned

For this purpose, I focus on an important factor in the development of the several nations, the institution of federalism. For most of the last 300 years, the richest nation in the world has had a federal structure: the Netherlands from the late 16th through mid-17th century; England from the late 17th or early 18th through the mid-19th century; and the United States from the late 19th century until the late 20th century. A specific form of federalism, here called *market-preserving federalism*, played a role in each of these countries, limiting the degree to which their political system could encroach upon markets.

The economic consequences of market-preserving federalism are well-known: federalism places restrictions on economic policymaking via limits on the discretion of national majorities. Less well understood is the central problem of the paper, namely, how a system of federalism provides for its own survival, i.e., what makes its restrictions credible? One of federalism's main effects is to limit the influence of distributional coalitions by decentralizing political power. It does so because no political authority has monopoly control over economic activity. If one jurisdiction attempts to regulate its firms in a way that consumers do not value, competitors from other jurisdictions will gain a competitive advantage.

For federalism to have this effect, however, the constitution must place credible limits on the central government's power. After all, what prevents distributional coalitions, limited in their influence at the state level, from pressing the federal government to intervene? The answer cannot simply be a written rule, for rules can be changed, avoided or ignored. To survive, federalism requires self-enforcing restrictions, i.e., ones that make it in the interests of national political actors *not* to respond to the inevitable political pressure that results from those interests frustrated by federalism's constraints (Riker 1964). This paper focuses on what I believe are general principles of a society's constitutional order needed to provide secure political foundations for markets.

This essay is divided into three parts. Part A focuses on the effects of federalism and puts these in a political perspective. Section 2 begins the discussion with an approach to the positive theory of constitutionalism, the emerging theory of the importance and role of political institutions in shaping state behavior. Section 3 describes the political theory of market-preserving federalism while section 4 discusses its role in the economic development of England and the United States.

Part B focuses on the deeper question of the political foundations of federalism, i.e., what made it and its restrictions credible? Section 5 analyzes how federalism was sustained in England while section 6 does so for the United States. These sections also explore the relationship between formal and informal constitutional constraints and the rule of law.

Part C turns to contemporary settings of economic reform in the former communist states. Section 7 compares the markedly different paths of economic reform in China and the former Soviet Union. It argues that a major difference — in part accounting for China's economic success — is that China's reforms began by providing the political foundations of reform, notably a form of decentralization that has much in common with market-preserving federalism. My conclusions and recommendations follow.

PART A: THE EFFECTS OF FEDERALISM

2. The Positive Theory of Constitutionalism

A society's constitution comprises the set of institutions governing political decisionmaking. The latter are those institutions or rules that determine how choices are made among various social and economic policies. For our purposes, a society's constitution determines the rules governing economic decisionmaking. In this sense, all societies possess a constitution, even those without an explicit or written constitution. Constitutions in the developed west are a specific subset of constitutions, possessing a range of specific characteristics. They tend, for example, to be explicit and are often written; to provide substantial guarantees of rights for citizens; and to call for a uniform treatment of citizens, regardless of ethnicity, race, or region. None of these specifics are necessary characteristics of a constitution.

One purpose of a positive theory of constitutionalism is to explain the relationship between the political organization of society and its economic performance.[4] What follows focuses on understanding how constitutional limits work and why some limits or constraints prove binding in practice. To that end, I explore three principles of positive constitutionalism.

The first principle of positive constitutionalism is that a constitution must provide for the means of its own preservation. In the language of modern economics, this requires that the constitution be credible or *self-enforcing* (North and Weingast 1989, Ordeshook 1992, Weingast 1991, 1992a,b). It is this aspect of constitutions that distinguishes our enquiry from the more traditional normative analyses that dominate the study of constitutionalism.

The second principle of positive constitutionalism is that democracy alone provides an insufficient political foundation for the protection of markets (Ordeshook 1992, Weingast 1992a). A critical characteristic of pure majority rule is that today's majority cannot bind tomorrow's. Indeed, because majority rule has no natural equilibrium or stable policy, a diversity of preferences implies that there virtually always exist policies that command a majority against the status quo.[5] Without some form of institutional commitment to a set of policies, those policies are subject to reversal at some future point by a new majority.

The implication for economic reform is that although today's majority might favor reform, tomorrow's might favor a massive redistribution of resources that destroys the market. This conclusion holds even if citizens unanimously favor certain broad political objectives. The potential for instability exists despite unanimous agreement on the broad goal of economic reform because citizens inevitably disagree about the details of marketization and the distribution of the burden of economic activity. While all may favor a thriving market, they will disagree about how fast one should be developed, what sectors should be reformed first, and especially who should be taxed and subsidized. They will also disagree

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[4] See, e.g., Elster (1991), Hardin (1989), Hammond and Miller (1989), North (1981, 1990), Ordeshook (1992), Riker (1980), Weingast (1992a). Much of Brennan and Buchanan's (1984) work is also included, though much of it is also normative in character.

[5] See Ordeshook (1992) and Riker (1980, 1982). This result has a long history and involves four decades of results from social choice theory. Starting with Arrow and Black in the late 1940s and early 1950s, important contributions have been made by Cohen, Hinich, Kramer, McKelvey, Ordeshook, Riker, Schofield, and Schwartz. Specific references may be found in the above citations.

about how to resolve unanticipated problems. Differences in preferences will arise about how to distribute the economic burden of a future crisis and how to make policy tradeoffs between coping with the immediate problem and allowing for long-term economic growth. This, in turn, allows for major shifts by majority, potentially creating the basis for the equilibrium trap discussed above.

The third principle of positive constitutionalism puts the second principle's conclusion in a more positive light: One purpose of political institutions is to provide for *limited government*, i.e., for the durability of rights and policies via restrictions on future political discretion.[6] In terms of the reform process, the potential for shifting majorities reinforces the tendency to alter policy in the face of unexpected, large problems. One way to mitigate the disincentive effects created by the tendency for "unpredictable reinterventions" is to reduce the political discretion of future majorities. If appropriately structured, institutional limits may mitigate precisely those political decisions that provide the adverse feedback effects. When the future potential for majority opportunism is limited via a constitutional constraint, the political risk to economic entrepreneurs is lowered.

The second and third principles of positive constitutionalism show that the stability of economic and political rights is not generated by democracy per se. The problem of instability demonstrates that relying on direct, unconstrained majority voting does not provide the basis for political stability. Indeed, the theory shows, paradoxically, that stability arises from restrictions on the ability of future majorities to alter policy.

To some, the third principle's conclusion may seem anti-democratic. This judgement reflects the growing but largely unquestioned identification of democracy with unfettered majority sovereignty, i.e., an absence of restrictions on today's majority. Unfortunately, this identification necessarily implies that today's majority cannot make long-term

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[6] This result has a long history and, as Bernholz (1993) emphasizes, animated such thinkers as Hobbes, Locke, Montesquieu, and later, the Federalists. For modern theories of majority rule, see the debate between Riker (1980) and Ordeshook (1980); for Congress, Shepsle and Weingast (1987); for the judiciary, Landes and Posner (1975); for policy in general, McNollgast (1989) and Moe (1990); for constitutions, Buchanan and Tullock (1962), Brennan and Buchanan (1984), Holmes (1988), Ordeshook (1992), and Weingast (1991); and on majority sovereignty and the Federalists, see Hammond and Miller (1989).

commitments, for anything promised today is subject to revision tomorrow. The ability to commit is well-known to be a valuable instrument for improving individual welfare.[7] Moreover, as the discussion of reform suggests, it is essential for attaining many of the fundamental societal goals.[8]

With respect to the transition from socialism to markets and democracy, our approach to constitutions suggests the following question: If economic and political freedom are essential ingredients of a successful transition, what constitutional characteristics are necessary to achieve that success? What specification of economic and political freedoms are required? The theory of positive constitutionalism is sufficiently new that no complete answers exist to these questions (North 1993). And yet, as I suggest below, some elements of an answer exist.

3. A Political Theory of Federalism[9]

The essence of federalism is that it provides a viable system of political decentralization. Although the political theory of federalism has a long history, it is useful to start with Riker.[10] In his seminal work on the

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[7] This conclusion is derived in a remarkably diverse set of contexts, e.g., Elster (1979), Holmes (1988), Milgrom and Roberts (1992).

[8] In his classic contribution to democratic theory, *Liberalism Against Populism* (1982), Riker demonstrates that the theory of social choice does not provide an argument against democracy per se. Rather, the emphasis on restrictions on today's majority reflects the tradeoff between the ability to provide policy durability — i.e., to make long term commitments — and the freedom to choose tomorrow. The question seems not to be whether restrictions on today's majorities are bad, but the source of those restrictions. The fundamental political dilemma of an economic system demonstrates the value of credible political commitments — even though the latter necessarily involves tying the hands of future majorities. The three principles combine this logic with the theory of social choice to show that the necessary political commitments involve institutions that limit future political discretion.

[9] This section draws on the work of Aranson (1991), Riker (1964) and Weingast (1992a).

[10] See, e.g., Brecht (1945), Codding (1961), Freeman (1893), Friedrich (1968), Hayek (1939), Riker (1964), and Wheare (1946). Most of the above theorists discuss the conditions which follow, often implicitly. Often, however, the critical third condition is omitted.

political theory of federalism, Riker (1964:11) defines a political system as federal if it has three characteristics: a *hierarchy* of governments, i.e., "two levels of governments rule the same land and people"; a *delineated scope of authority* so that each level of government is autonomous in its own, well-defined sphere of political authority; and an institutionalized degree of *autonomy* of each government in its own sphere of authority. In what follows, I focus on a subset of federal systems called *market-preserving federalism*. A federal system is market-preserving if it has a fourth characteristic, *locus of economic regulatory authority*, which requires that: (a) the authority to regulate markets is not vested with the highest political government in the hierarchy and (b) the lower governments are prevented from using their regulatory authority to erect trade barriers against the goods and services from other political units.[11]

Each of these characteristics plays an important part in federalism's market-preserving role. The first two are clearly defining characteristics that establish minimal or necessary conditions for a federal system. But they alone are not sufficient. The reason is that federal systems are not generally viable if they are based solely on the discretion of the highest political authority since that delegation of power can always be reversed. As Riker observes, a central problem for federal systems is that the highest or central government may *overawe* the lower units. A viable system of federalism must therefore prevent this.

Although the first three characteristics define a system of political decentralization, they say nothing about the authority over economic issues. To have market-preserving economic effects, federalism must also have the fourth characteristic. The central government's authority to make economic policy must be limited; this authority must be placed in the hands of the lower political units.

Economic consequences of market-preserving federalism

The economic consequences of market-preserving federalism, explored by Hayek (1939, 1960) and made famous by Tiebout (1956), are

[11] Riker also emphasizes that there must be some abiding reason underlying the union, typically in the form of a public good. Defense is the public good he emphasizes, but others are also possible such as an economic customs union. This condition is also mentioned by other theorists of federalism.

sufficiently well-known that they need only be briefly described here.[12] The first effect of market-preserving federalism is that the prohibition on economic regulation at the highest level implies that privately valuable, politically created monopoly rights and restrictions cannot be established for the entire economy all at once. The second, and perhaps the best studied effect of market-preserving federalism, is the induced competition among lower units of the federal structure. As long as capital and labor are mobile, market-preserving federalism constrains the lower units in their attempts to place political limits on economic activity since resources will move to other jurisdictions.

The literature on the economic effects of federalism yields two principal conclusions about public policy choice. First, competition implies that only those restrictions that citizens are willing to pay for will survive. Were a jurisdiction to respond to political pressure by attempting to cartelize an industry, the mobility of labor implies that it will relocate in more compatible jurisdictions. If a jurisdiction attempts to confiscate the wealth of an industry, the mobility of capital implies that firms will relocate. The mobility of resources thus raises the economic costs to those jurisdictions that might establish certain policies, and they will do so only if the political benefits are worth these and other costs.

Political competition implies that jurisdictions will compete for residents and economic activities via their menus of public policies. Residents and economic actors make location decisions based on those menus. This yields a diversity of public goods with some jurisdictions providing lower taxes and a lower level of public goods and others with higher taxes and a higher level of public goods.[13]

Federalism thus greatly diminishes the level and pervasiveness of economic rent-seeking and the formation of distributional coalitions. Competition among the lower units limits the success from rent-seeking. Because such regulation qua rent-seeking can only be local, it provides firms outside that locale with a competition advantage over those being regulated. Nonetheless, when, in a given locale, individuals' willingness

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[12] Aranson (1991) provides the best modern statement of the economic effects of federalism.

[13] Here too, qualifications to the general results have appeared; see Aranson (1991) and Inman (1987).

to pay is sufficient, local governments will provided a specific array of goods and services.

Sustaining market-preserving federalism

A principal feature of the economic analyses of federalism is that they take the structure of federalism's division of political authority as given. For purposes of understanding the effects of an on-going and viable system of federalism, that assumption is reasonable. Nonetheless that assumption bypasses the question of why the system of federalism is viable. In terms of the political theory of federalism, the economic analysis of federalism ignores how Riker's third characteristic is achieved. While I postpone until section 4 the discussion of how it is achieved in practice, the above discussion demonstrates why it is necessary.

The beneficial economic consequences of federalism result from the political decentralization of economic authority that induces competition among the lower political units. Some institutionalized constraint on the central government's political authority to regulate is essential to this system's success. Were the structure of political authority solely at the discretion of the central authorities, the beneficial effect could not be realized. Its officials would respond to the interests' appeals for intervention in precisely the same manner as if there were no federalism.

Without a mechanism to prevent this action at the central level, market-preserving federalism would be neither viable nor market-preserving. In order for federalism to have its intended economic consequences, the third condition is essential: Something must provide durability to the limits on the central government's authority to regulate directly, to usurp that authority, or to simply remove its earlier gra of that authority to the lower levels.

4. Market-Preserving Federalism in Practice

This section surveys a subset of systems characterized by market-preserving federalism: 18th century England and 19th and early 20th century United States.[14]

Federalism in England

Though the British do not use the label federalism, by the definition given in section 3, 18th century England was a *de facto*, if not *de jure*, federal system.[15] First, the national and local governments were important and distinct sources of political authority. Second, by the beginning of the 18th century, the national government was limited in its ability to regulate the domestic economy (though the international economy was heavily controlled). The constitutional changes made over the previous century and solidified in the Glorious Revolution (1688-89) abolished, greatly restricted — or granted jointly to parliament and the crown — many of the powers used by the deposed Stuart kings. Throughout the Stuarts' reign, rent-seeking activity was prevalent (Ekelund and Tollison 1981), and many of these constitutional changes were aimed at preventing it.

From the standpoint of this paper, England's market-preserving federal structure played a critical role in fostering the industrial revolution.[16] The importance of the induced competition among localities is revealed by its effects on the pattern of local economic controls. In nearly all the

[14] Though what follows focuses only on Anglo-American cases, very similar arguments can be made for the role of federalism in the economic rise of Switzerland (following the constitutional reforms of 1874) and Germany (following the constitutional reforms of 1871).

[15] The reason it was not a *de jure* system of federalism is that 18th century England clearly did not possess political jurisdictions such as states, cantons, or lander that are associated with states typically labeled as federal. A more complete approach to federalism would distinguish between federalisms involving political units of that type (e.g., "classical federalism") and those that do not ("non-classical federalism"). From the standpoint of this paper, that distinction is unimportant. As suggested by the definitions in section 2, the political and economic consequences follow from division of political authority over economic policy and property rights, regardless of whether the federalism is "classical." That 18th century England fits this despite the absence of states or lander suggests that traditional approaches to federalism are based on formal or legal distinctions that are irrelevant for the questions studied here.

[16] These institutions had a second critical effect, namely, they underpinned the rise of Great Britain to the premier world power. The increased security in property rights proved critical in this rise, for it allowed an almost immediate and spectacular growth in public capital markets. This theme is developed in North and Weingast (1989) and especially Weingast (1991b).

established commercial centers of England, production was controlled via local regulatory laws. Various industries and professions, for example, were governed by gilds whose regulatory controls limited competition, pricing, entry, and training. These constraints handicapped potential entrants, including those attempting to devise new forms of economic activity or to promote significant innovation for existing activities.

Two interrelated aspects of the industrial revolution concern us. First, economic historians emphasize that one of the central factors underlying the industrial revolution was the absence of enforcement of these restrictions (see, e.g., Mokyr 1988). Second, that absence was neither uniform nor accidental (see Hartwell 1971 and esp. North 1981, ch. 12). Importantly from our perspective, it reflected local political policy choices. As is well-known, industrialization did not proceed in the established commercial centers but instead in the north. One of the foremost scholars of the industrial revolution, T.S. Ashton, concludes that this had a decisive effect:

> It is beyond doubt that employers often transferred their activities from corporate towns in order to escape from restrictions imposed by privileged groups of workers, or from municipal regulations as to labour. . . [T]he movement of industry was rarely induced by the prospect of lower wages in the new area. Quite the reverse: 'we daily see manufacturers leaving the places where wages are low and removing to others where they are high,' it was said in 1752. (Ashton 1955, 94.)

In an effort to evade local economic restrictions, many of the new entrepreneurs so critical to the industrial revolution located in areas traditionally outside the commercial orbit.

Root's (1992) comparison of England and France reveals an important difference in the legal response to the locational decisions of new producers. In England, Parliament and many local Justices of the Peace (JP) refused to extend guild restrictions and jurisdiction to the countryside. Typically chosen from the local gentry, JPs were unpaid and owed only nominal allegiance to the crown, particularly after the Glorious Revolution. They thus cared far more about local prosperity — often their own — then implementing policies for the benefit of those outside their jurisdiction. "By contrast, the French royal courts supported the claims of French guilds to regulate rural production," thus hindering rather than fostering industrial development in France (Root 1992, ch. 5, p. 13).[17]

Two aspects of England's market-preserving federalism fostered economic growth during the industrial revolution. First, precluding the national government's authority to regulate economic activity prevented it from responding to efforts by the established economic interests to provide national controls that would have effectively prevented many of the new industrial activities.[18] Second, the induced political competition among local jurisdictions implied that some localities were willing to take on the extra burdens in exchange for the prospects of generating new forms of economic activity, local employment, and taxes. The absence of this politically-induced avenue of economic innovation, would have significantly hindered the industrial revolution. Federalism thus played a necessary and decisive role in the *political* foundation of England's industrial revolution.

Federalism in the United States

At its inception, the U.S. Constitution granted the states the power to provide their citizens with various forms of public goods. The historical record shows they took advantage of these powers in different ways (Handlin and Handlin 1947, Hartz 1948, Hughes 1977). The Constitution also allowed states to respond to interest groups and distributional coalitions, but limited their influence to particular states. Federalism provided strong limits on the degree to which these coalitions could impose uniform national regulations.

The commerce clause provided one of the Constitution's central pillars in its protection of markets (for a discussion of this issue, see Aranson

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[17] These conclusions are shared by a range of scholars. Landes (1969:18-19) emphasizes that "a crucial element in the rise of industrial capitalism [was] the spread of commercial manufacture from the towns to the countryside. . . [Yet] **the very unevenness of this development . . . is testimony to the fierce and successful opposition it encountered from privileged interests in the towns**" (emphasis added). See also Cunningham's (1903: 502) discussion of the rise of the Yorkshire cloth trade as an attempt to "escape from the supervision of employers and regulations passed by oligarchical associations of capitalists."

[18] Indeed, the Stuarts' inclination toward this form of regulation, paralleling similar inclinations in absolutist France, played an important role in the domestic opposition to them and the Civil War in the 1640s and the Glorious Revolution in the late 1680s.

1991).[19] This clause prevented states from regulating interstate markets and from erecting various forms of trade barriers. It also limited federal regulation to problems truly national in scope, an authority not exercised via direct intervention in domestic markets for the first 100 years of the Constitution. As Hayek (1960) observed, federalism thus proved the solution to the dilemma of how to limit the states' protectionist activities without providing the national government with too much power.

The consequence was one of the largest common markets in the world, characterized by strong protection of property rights and an absence of regulation. The Constitutional limits on state and federal governments served as the critical political foundation for the enormous expansion of the economy during the 19th century. By mid-century, the pattern of interregional trade had transformed the nation from one of largely self-sufficient farmers at the time of the Constitution to one of striking regional — and international — economic specialization (North 1961, Fogel 1989). The growth in national wealth reflected this pattern of specialization.

In broad outline, the South specialized in the production of cotton and other exports. During the early part of the century, strong and growing international demand for cotton proved the "engine of American economic growth" (North 1961, Lee and Passell 1979). The Northeast specialized in providing commercial services, e.g., transporting cotton to European markets. It also provided insurance, marketing, and other financial services attending the growth and delivery of these exports. The Northwest, largely self-sufficient at first, increasingly came to specialize in growing food. These crops were shipped south along the water routes and, increasingly over time, east via canals and railroads for eastern markets. On the eve of the Civil War, a large portion of midwestern farmers were specialists in international markets, producing grain bound for Europe (Bogue 1963, Fogel 1989).[20] Except for the interruption of the Civil War (including its lasting deleterious effects on the South), this

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[19] The commerce clause was by no means the sole clause designed for this purpose (e.g., the privileges and immunities clause).

[20] The "transportation revolution" underpinned this system of specialization (Taylor 1951, North 1961, Fogel 1989). Traditionally dated from 1815, this revolution provided roads and canals early in the century and, later, railroads. The main economic consequences of the revolution resulted from the dramatic fall in transportation costs. For example, the cost of moving goods from Cincinnati to New York fell by an order of magnitude between 1815 and 1860 (North 1961, ch. XI).

process of growth and specialization continued throughout the century. By century's end, the United States was the richest nation in the world.

The relatively unregulated aspect of the thriving markets of the 19th century is so taken for granted by modern economic historians that it is not analyzed in any detail (see, e.g., Lee and Passell 1979 or Fogel 1989 Part I; an important exception is Temin 1991). Neoclassical economics, taking property rights as given, proceeds as if the secure economic rights in 19th century were inevitable or immutable characteristics of the United States. And yet the absence of federal intervention was hardly inevitable. The striking degree to which intervention failed to occur in practice, instead demands an explanation.

The pattern of American economic growth depended critically on the absence of regulatory controls that would have hindered the growth of interstate trade and regional specialization. The absence of such controls was not due to lack of demand for intervention, however. Just as today we observe a host of displaced economic interests providing political support for intervention to halt or reverse the economic changes accompanying economic growth, so too did such groups provide demands for political intervention to limit economic change. Thus, commercial agents along the traditional water transportation routes fought the growth of the railroads. Cattle producers in upstate New York sought relief from cheaper producers farther west. Nascent manufacturers in the northeast fought cheap land policy at the federal level because lower prices increased immigration rates. Although the reasons varied from case to case, these interests were by and large unsuccessful in their attempts to gain beneficial legislation.[21]

The absence of debilitating regulatory intervention critically depended on the common market's secure political foundation limiting the ability of state and federal governments from responding to distributional coalitions. For well over a century, domestic, interregional markets were not only unregulated but *protected from regulation* by the Constitution's constraints.

[21] See Miller (1971) on the railroads. For example, commercial interests utilizing the Mississippi were the main opponents to the building of a railroad bridge across that river, delaying it from the 1840s until the late 1860s. See Passell and Schmundt (1971) on northeastern interests and immigration policy. More generally, see Chandler's (1977) systematic study of industrial change in the second half of the 19th century.

As emphasized above, federalism played a central role in these constraints.[22]

PART B: CREDIBLE COMMITMENT TO FEDERALISM

The discussion has thus far deferred addressing the critical question, what provides for federalism's durability? The answer differs for each circumstance. This reflects the necessity to embed federalism in each political system so that its restrictions are self-enforcing, i.e., so that actors within the system find it in their interests to abide by them. Because the circumstances of each system differ, the way in which it embeds federalism will also differ. Part B discusses the principal constitutional mechanisms that underpinned federalism in England and the United States. These are discussed in turn.

5. The Durability of Market-Preserving Federalism and The Rule of Law in 17th and 18th Century England.

The task of this section is twofold: to develop a model of a constitutional consensus about the limits on governmental action and to apply it to help explain the absence of economic intervention in 18th century England.

The phenomenon that much of the industrial revolution took place outside the traditional commercial areas rests on the two aspects of market-preserving federalism: decentralized regulatory authority, which allowed local variation in economic regulation, and the absence of national regulatory authority to extend economic controls to cover those areas that did not have them. This section examines a critical aspect of the English system that helped account for the absence of national controls. A range of elements contributed to this result. First, among all states in early

[22] Of course, the constitutional underpinning of market-preserving federalism has not lasted until the present. The most important Constitutional changes in federalism occurred in response to the problems of the 1930s and the enormous increase in the political demand for federal intervention. At this time, the Supreme Court removed the commerce clause's strong prohibitions on the national regulation, thus limiting its role in the maintenance of federalism (see Aranson 1991 and Weingast 1992a).

modern Europe, England had the strongest tradition of private property rights. Second, after the Glorious Revolution, Parliament served as a political counterbalance to the crown, by and large opposing national economic intervention. Third and most important from our standpoint, was the rise of a civil society and the rule of law at the end of the 17th century whereby a consensus emerged opposing national economic intervention.

The question we study concerns the limits on sovereign or state power. Why are institutional constraints on government observed? In particular, given the omnipresent temptations to avoid, break, ignore, or end-run these restrictions, what preserves limited government? One approach concerns the notion of "legitimacy": a regime finds it difficult to violate provisions of a constitution that its citizens feel are legitimate. Although promising, this approach is fraught with conundrums and problems: What determines when a constitution is legitimate? How are we to operationalize the notion so that it is not tautological? And what are the mechanisms underpinning legitimacy, i.e., how is a general notion of legitimacy translated into the preservation of a specific constraint on government?

The purpose of this section is to develop an approach to the problem of legitimacy in a way that answers these questions.[23] To make sense of this concept, we begin with individual citizens. Legitimacy is rooted in the ideas held by individual citizens. In particular, we assume that each citizen holds a specific view about the appropriate bounds on governmental action. This defines what actions that individual considers legitimate and illegitimate.

Defined in this way, the problem of legitimacy creates two massive social problems. The first arises because nothing per se brings citizens to a uniform view. Indeed, economic, political, and social differences among individuals work in just the opposite manner — to pull individuals apart so that they have different notions of what actions are legitimate. In the language of game theory, the problematic nature of citizen agreement on the appropriate bounds of government creates a *coordination* problem.

The second problem concerns the relationship between a citizen's views about the appropriate bounds on government and what happens when a violation of those bounds occurs. Put simply, even if all the citizens

[23] What follows summarizes the model and results presented in Weingast (1993).

agree on the appropriate bounds of government, what keeps the government from ignoring those bounds?

The importance of these two problems arises because they hold the key to policing constraints on government. Constraints can be policed only when citizens react in concert against the government in the face of violations. Success requires the conjunction of two aspects of citizen behavior: First, that citizens react to violations by punishing the government and, second, that they hold sufficiently similar views about the appropriate bounds on government so that they react in concert. In the language of game theory, we are searching for an equilibrium to a game in which the government has the opportunity to violate constraints but chooses not to do so. The key to policing constraints is that the fortunes of the government depend on it, i.e., that violating constraints leads to the withdrawal of citizen support and hence to a loss of power.

The model is based on two assumptions about the relationship between a sovereign and his citizens. First, a necessary condition for an individual citizen to support the sovereign is that he not transgress that citizen's rights. Second, remaining in power requires that the sovereign retain a sufficient degree of support among the citizenry. Without the necessary support, the sovereign loses power.

The model

We suppose there is a single sovereign, S, and two groups of citizens, A and B. The groups of citizens have different views about the legitimate boundaries of the state and hence what actions by the sovereign are considered a fundamental violation of their rights. In this game, the sovereign needs the support of at least one of the two groups in order to retain power.

The sequence of actions in this game is shown in Figure 1. S moves first and may choose to attempt to transgress against both A and B, against A alone, against B alone, or against neither. After S moves, A and B move simultaneously.[24] Each may choose to acquiesce or to challenge the sovereign. Challenging is costly; moreover, each may challenge even if the sovereign has not transgressed. If both A and B challenge, the

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[24] The simultaneous move between A and B is shown in the figure as A moving first followed by B, but, as indicated by the dashed ellipse or "information set" around B's two notes, where B does not know A's decision when he must choose.

sovereign is deposed. Any transgression attempted by the sovereign is rebuffed. If only one group of citizens challenges S, the challenge fails and any transgression attempt by S succeeds. Of course, if both A and B acquiesce, any attempted transgression succeeds.

The payoffs from this game are given in Table 1. Power is valuable to the sovereign, and he loses 1 if he is deposed. Successful transgressions are also valuable to him and are worth 2 each. A transgression against either group costs that group 3, reflecting the fact that there are economic costs associated with transgressions, e.g., a loss of wealth. Challenging costs each challenger 1 regardless of whether it is successful.

Outcomes are determined by the strategy combinations chosen by the three players. If S attempts to transgress against both A and B and both acquiesce, the transgression succeeds and the payoffs are: 5 to S, 1 to A, and 1 to B. If S attempts to transgress against both A and B and both challenge, the transgression fails and S loses power, resulting in payoffs of 0, 3, 3. The Pareto optimal outcome for society occurs when no transgressions or challenges are attempted (the parties obtain 1, 4, and 4, respectively).

While more complicated than the standard prisoners' dilemma, the structure of this game resembles that of the prisoner's dilemma. This holds because responding to transgressions is costly to each citizen group. Consider the set of incentives facing the citizens if S attempts to transgress against B. B prefers that both challenge. Notice, however, that A has a dominant strategy: no matter what strategy B plays, A prefers to acquiesce. Knowing this, B will acquiesce.

This structure of interaction allows the sovereign to transgress some citizens' rights and survive.[25] In the one-shot game, there are three pure strategy equilibria, and the Pareto optimal strategy combination with no transgressions is not among them. Which equilibria occurs depends in part upon the reaction functions of the citizens groups to a transgression. The worst outcome for the citizens — where the sovereign transgresses against both — is an equilibrium. This occurs if citizens acquiesce whenever they

[25] Throughout we use the concept of subgame perfection as an equilibrium concept, defined as follows. A *strategy* is a specification of the action a player will take at every branch of the game tree. An *equilibrium* is a set of strategy combinations such that no player has an incentive to deviate given the strategies of others. The equilibrium is *subgame perfect* if it remains an equilibrium when restricted to every subgame.

are the target of a transgression. Acting alone and taking the behavior of the others as given, each citizen group can only increase its costs by challenging but it cannot change the outcome.

On the other hand, A and B might both play a different strategy, namely that they challenge S if and only if both are the targets of a transgression. In this case, there are two equilibria depending upon which citizen group S chooses as a target. Suppose that S chooses to target B in every period and that A and B respond as just suggested. Then S has no incentive to deviate: Transgressing against both leads to being deposed; transgressing against A instead of B is no better; and transgressing against neither leaves him worse off. Furthermore, neither citizen group has an incentive to deviate. For A this conclusion is obvious. For B, it follows because it can do no better. Given that it alone is the target and thus that A will not challenge, challenging will not change the outcome but will increase its costs. Hence B is better off acquiescing if it alone is the target.

The situation is more complicated when this game is repeated, i.e., when the interaction between the sovereign and citizens is on-going. Given the structure of payoffs, the "folk-theorem" applies, implying that virtually any outcome can be sustained as an equilibrium of the repeated game (Fudenberg and Maskin 1986). In particular, any of the equilibria of the one-shot game is an equilibrium of the repeated game. The existence of multiple equilibria is a problem for prediction, an issue we return to below.

The folk-theorem implies that the Pareto optimal outcome can be sustained. The key to this result, as with the single-shot game, concerns the behavior of each citizen group when the sovereign attempts to transgress against the other. The difference is that repetition provides the opportunity for citizens not only to punish the sovereign, but to punish one-another. The Pareto optimal outcome is supported by both groups challenging the sovereign when the sovereign attempts to transgress against either. The reason why that behavior can be supported under repeat play is that, as in the repeated prisoners' dilemma, the players can use "trigger" strategies to punish one another for failure to cooperate. If, say, A fails to challenge the sovereign when the latter attempts to transgress against B, then B can retaliate by failing in the future to challenge the sovereign whenever the sovereign attempts to transgress against A. This behavior by B allows the sovereign to transgress successfully against A.

B's trigger strategy provides A with the following strategy choice. It can acquiesce today, avoiding the cost of 1, and then face losing 3 in all future periods; or it can challenge today, costing 1 but maintaining 3 in all future periods. Clearly, when A does not discount the future too heavily, it will prefer the latter, so that B's threat strategy induces A to challenge the sovereign when the latter attempts to transgress against B alone.

Unfortunately, the Pareto optimal outcome is not the only equilibrium. Although that equilibrium is normatively attractive, it will not inevitably occur. The game might instead yield any of the three equilibria of the one-shot game, allowing successful transgressions against some or all citizens. In particular, the sovereign may transgress the rights of some citizens while retaining the support of others. This is a stable pattern, and none of the players, acting alone, can change it.

Thus far, we have taken the definition of a transgression as given, ignoring the content of the underlying views of individuals about these transgressions. The most natural way to interpret a transgression in the model is as an act directed against a group of citizens, for example, an attempt to confiscate their wealth. Another subtler way to think about a transgression is to disassociate it from the target. For many citizens, the importance of a transgression lies in its nature regardless of who is the target. This view of transgressions implies that citizens have a duty to challenge the sovereign when the latter attempts a transgression, regardless of the latter's target. This view still allows for a diversity of opinion over what acts constitute transgressions. The question then becomes, given this interpretation of transgressions and citizen duty, what combinations of beliefs about the nature of transgressions can be supported in equilibrium?

Given the second interpretation of a transgression, one way to think about the problem of multiple equilibrium is that the question of which equilibrium will occur depends on the diversity of beliefs about transgressions and about citizen duties when the sovereign attempts to transgress against other citizens. Indeed, as Ferejohn (1990) argues, in the context of multiple equilibrium, we can suggest which equilibrium will result based on the pattern of beliefs in a society.

In the present context, Ferejohn's argument implies the following. Suppose there is a diversity of preferences over outcomes, especially if citizens' economic circumstances differ considerably — some might be wealthy elites; others, successful commercial agents or economic entrepreneurs; others, farmers who own their land; still others, peasants who work land they do not own. Under these circumstances, the nature of citizen views about the appropriate role of the state and what actions constitute a transgression are likely to differ widely. Because there is no natural mechanism to produce a consensus on these issues, the most natural equilibrium of the game is the asymmetric one. Put another way, the diversity of preferences provides an impediment to the development of the Pareto optimal equilibrium, making it more likely that the game will result in one of the asymmetric equilibrium in which the sovereign transgresses the rights of some and retains the support of others.

Ferejohn's argument also implies that, for those issues over which citizens agree about the nature of a transgression, the Pareto optimal outcome can be supported. When the state of agreement in society is large, producing something approaching a consensus, a sovereign who attempts to transgress against citizens cannot survive.

Summary and implications. The model shows that it is costly for the citizens to police the sovereign or government. Policing boundaries on the state require that citizens be willing to bear this cost when the state violates them. Yet, if citizen beliefs about the appropriate boundaries on the state differ considerably, it is difficult for them to react in concert to state actions. Indeed, this diversity allows the sovereign to form a coalition with one group of citizens against another, allowing the sovereign to transgress boundaries considered fundamental by other citizens.

The approach thus suggests that the problem of policing a state or sovereign is a form of a coordination problem, i.e., of coordinating citizens' beliefs about the appropriate role and limits of the states. In this sense, it is possible for a constitution to serve as a coordinating device, that is, to help citizens coordinate their strategy choices so that they can react in concert and police state behavior.[26] An appropriately chosen set of public rules embodied in a constitution can play this role because it provides each citizen with a similar way of judging and reacting to state action. Of course, the availability of such a mechanism in principle does not tell us what circumstances may be used in practice.

In sum, the approach demonstrates that a central aspect of creating limited government is that citizens or their representatives construct a mechanism that solves the coordination problem. Such a mechanism

[26] This point is made generally by Hardin (1989) and, in the current context, by Weingast (1992b).

allows them to overcome exploitation by the sovereign based on the natural diversity of preferences about the appropriate boundaries of the state.

Application of the approach to the Glorious Revolution

This approach has considerable implications for the constitutional changes following the Glorious Revolution in England and the rise of a national consensus about the appropriate boundaries of the state.

The 17th century was one of considerable political turmoil. Within a decade of the accession of the Stuarts in 1603, problems emerged between the sovereign and many of his citizens. This century included a Civil War and the beheading of the king (1640s), a restoration of the monarchy (1660), and the Glorious Revolution (1688-89) which deposed the last of the Stuart kings, James II, in favor of William and Mary.

Throughout this century, the citizenry was deeply divided over the role of the sovereign, the appropriate limits on state behavior, and the benefits of various public policies. By century's end, two political coalitions had emerged, called Tories and Whigs. Whigs were more focused on commercial activities, favored secure property rights, low and stable taxes on economic activity, and an activist profile in international relations to promote and defend their economic claims around the world. They also sought explicit limits on sovereign behavior. Tories, on the other hand, cared much less about commercial activity, wanted a low international presence, and preferred low and stable taxes on land, their primary source of wealth. They also strongly supported the Church of England and opposed explicit limits on the crown.[27]

During the reign of the late Stuarts (from the Restoration to the Glorious Revolution) and especially by the mid-1670s, the Tories supported the crown while the Whigs opposed it. Moreover, the late Stuarts transgressed significant rights of the Whigs while retaining support of the Tories. The most important sovereign transgression concerned the

[27] "It is an oversimplification to see the Whigs as the party of business and the Tories of seigneurial power. Some of the greatest aristocrats were resolute Whigs, and some of the keenest battles in the City of London were fought between rival groups of businessmen with Whig and Tory backing. But one can safely contrast emphasis on commerce as a point in the Whig profile, and emphasis on agriculture as a point in the Tory one. So, too, the Whigs tended to internationalism — to 'Dutch finance' under William and 'no peace without Spain' under Anne; while the Tory was inward-looking and protectionist . . . the Tory tended to peace, the Whig to war." Carswell, (1973, 40-1).

campaign to "pack the constituencies." In the early 1680s, the crown began its campaign to disenfranchise the major sources of Whig opposition. It proved a huge success.[28] The Whigs' appeals about the fundamental political boundaries of the state and their legitimate political rights went unheeded by the Tories.

The events that occurred next are straightforward in outline, though the explanation for them has been debated for over three hundred years. First, Charles II died and was succeeded by his brother, James II. Second, in reaction to a dispute with the Tories, James attempted to disenfranchise his own constituents. Although this attempt nearly succeeded, it ended in dismal failure. The result was a united political nation against James II, forcing him to flee.

The Glorious Revolution was more than a simple coup, however, for it also resulted in significant constitutional changes. In particular, the Tories came to agree with the Whigs that explicit limits on the sovereign and the state were required. While the two coalitions disagreed about the content and role of these limits, they agreed that not only were limits necessary, but so too was a consensus about those limits (Schwoerer 1981). The result was the Revolution Settlement passed by Parliament in early 1689. From our standpoint, the key is the Bill of Rights, a set of two lists. The first identified those actions of the previous sovereign that constituted fundamental violations of citizens rights. The second provided a list of activities the sovereign could no longer undertake. While sovereign power would wax and wane over the next century, the limits established in the Revolution Settlement were, by and large, adhered to.

These events are readily interpreted in terms of the above model. Prior to the Revolution, citizens fundamentally disagreed about what actions they considered fundamental violations of their rights. Marked divisions in 17th century England prevented the formation of a shared system of beliefs about the critical matters such as the role of the state, the limit of sovereign power, citizen duty, and the appropriate definition of economic and political rights. The diversity of beliefs allowed the crown to transgress rights held as fundamental by the Whigs as long as the Tories were willing to acquiesce. This described the situation from at least the

[28] Jones (1972, 47) reports that of the 104 formerly Whig strongholds rechartered between 1681 and 1685, only one returned a Whig to the next parliament in 1685.

mid-1670s through the mid-1680s. This situation was seemingly stable, reflecting the nature of the asymmetric equilibrium of the game.

James's move against his own constituents broke this pattern, losing him the support required to retain power. Not only was he removed from power, but his actions caused a wholesale and speedy revision in opinions and beliefs about fundamental issues. This led to the construction of a new consensus that provided a clearer definition of the legitimate actions of the state and of citizen duty.

These changes reflect an attempt to construct a coordinating device. The constitutional changes such as the Bill of Rights played this role by defining what actions constituted a fundamental transgression. The new consensus was critical to preventing further transgressions. Reflecting the achievement of coordination, the American Justice Bradley, writing in the late 19th century, observed that a constitutional violation "would produce a revolution in an hour."[29]

Because the new boundaries were both explicit and consensual, they fundamentally changed the interaction between the citizenry and the new sovereign. For many of the most central political issues of the era, a single set of limits on sovereign behavior had emerged, negotiated by leaders of the opposing parties and made explicit in the Bill of Rights. This process resulted in a set of shared beliefs about what constituted a fundamental transgression by the state and about what citizens should do in the face of these transgressions. These shared beliefs implied that citizens would react in concert against any future sovereign transgression, thus ensuring that their political and economic rights were more secure.

Sustaining market-preserving federalism in England

Given the distinct hierarchy in English governments, the main question as to whether post-Glorious Revolution England was characterized by market-preserving federalism concerns the limits on national regulatory authority.

The post-Glorious Revolution consensus about the limits of national regulatory authority reflected two factors. First, the clear and final elevation of the common law courts as the protector and promoter of private property rights effectively removed many of these decisions from

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[29] J. Bradley's dissent in the Slaughter House Cases (1873), quoted in Siegan (1992, 43).

the political realm. The history of these courts under the Stuarts reveal them as staunch defenders of private rights against intervention by the state.[30] During key controversies, several chief justices lost their positions because they would not rule in favor of the crown (see, e.g., Hirst 1986 and Hill 1980). Thus, one of the central consequences of the Glorious Revolution was that it established the "independent" judiciary and hence was much less subject to manipulation so as to favor regulation. The delegation of authority to the common law courts provided a limit on the authority of the state in economic matters (Weingast 1992b).

Second, after the Glorious Revolution, citizens more closely guarded local power, authority, and autonomy. Because violating local political liberty had been a principal factor in the campaign to pack the constituencies — and hence in the Revolution — citizens throughout England were wary of national interference with their authority. As Miller (1992, 53) suggests,

> The right, in most towns, to practice a particular trade or take part in municipal government was confined to a comparatively restricted group of craftsmen and traders possessing the "freedom" of their town or craft guild which gave them rights denied to other citizens. Municipal and other corporations (including colleges and universities) had been granted (usually by the Crown) the right to a measure of control over their own affairs: here "freedom" meant immunity from outside intervention.

Because both factors emerged as part of the constitutional consensus at the end of the 17th century. Deference to the common law courts and to local political authority thus became part of the political underpinnings of private rights and liberty that proved critical to the economic changes of the 18th century.[31]

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[30] Several notable controversies hinged on issues of economic intervention by the Stuarts at variance with common law, e.g., the issue of monopolies in the early part of the century.

[31] A third factor limiting the exercise of national regulatory authority concerned the changing basis of the consensus between Whigs and Tories over the appropriate limits on the state. As the chief proponents of limits on sovereign authority prior to the Revolution,

By way of summary, national interference with local power during the campaign to pack the constituencies produced a consensus that protection of local power against national interference was essential to maintenance of individual liberty and security. The consensus was embodied in the constitution, which played the role of a coordinating device necessary to establish the equilibrium in which citizens react in concert to violations of the limits on governmental action.

In this sense, the limits imposed on national power after the Glorious Revolution were backward looking, i.e., they were intended to prevent transgressions by the sovereign. Yet they had important — if unintended — economic effects. By strengthening local power and limiting the ability of the national government to intervene in the economy, the new English constitutional system provided for market-preserving federalism. This in turn proved a critical political component of industrial revolution, for it allowed local governments to ignore, avoid, or repeal the regulatory restrictions on the local economy that economic historians have emphasized were crucial to the success of the new entrepreneurs and enterprises.

More generally, this view has implications about the maintenance of the "rule of law," i.e., a government of laws not of the exercise of discretion by those in power. The model in this section shows that the views of citizens about the appropriate role of government are a fundamental determinant of the rule of law. When these views differ considerably, the state may take advantage of its citizens by violating the rights of some while maintaining the necessary support of others. Maintaining limits on governmental authority is thus a coordination problem among the citizens. Because the diversity of experience combines with the diversity of economic and political interest, a consensus is not likely to emerge in a completely decentralized, uncoordinated fashion. This shows why the construction of a coordinating device such as a constitution is so critical to the maintenance of boundaries on state action. Moreover, as I demonstrate elsewhere (Weingast 1993), this model has

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the Whigs and their constituents maintained their ideological views about the limits of government after the Glorious Revolution, even as their influence over national decisions increased. After the Revolution, particularly as the political dominance of the Whigs increased, the Tories became the chief proponents of limits in order to protect themselves (Brewer 1989). This implied that, over time, the consensus about limits on the state grew.

considerable application in other contexts, including both societies in which a consensus has been established and those in which such a consensus has failed to emerge.

6. The Durability of Federalism in the United States[32]

In terms of the political theory offered above, the United States was characterized by market-preserving federalism from the inception of the Constitution through the mid-1930s. The question addressed in this section is: Prior to the 1930s, what made this pattern of market-preserving federalism durable. i.e., what prevented the federal government from overawing the states? The immediate answer — that the constitution prevented it — begs the question, for it leaves both the issue of Constitutional interpretation and of Constitutional adherence as exogenous.

At the most fundamental level, the answer to the question is that not only did the Constitution proscribe intervention, but the vast majority of Americans favored this outcome. In terms of the previous section, a national consensus supported the limited role of the federal government. Because this view was so widely held, all the major parties prior to the 1930s championed it (the Federalists, the Jeffersonians, the Jacksonians, and the Republicans, respectively).[33] National parties not only promoted the view of a limited federal role, but created and maintained a series of institutional mechanisms designed to provide a credible commitment to limited federal government.

To see how the consensus translated into the mechanisms of Constitutional durability, consider the problem during the second party system, roughly 1828 through the early 1850s.[34] During this time, the nation was divided into free and slave states. This division had a critical influence on American history, including: the interpretation of the

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[32] The conclusions reported in this section are based on a new set of models of public law provided by the new "positive political theory" (PPT).. See, e.g., the papers in the recent symposium, *Georgetown Law Review* (1992).

[33] The one possible exception to this was the Republicans and the issue of slavery and the rights of the freedmen. These policies emerged only within the context of the Civil War. A version of the view that follows applies to the bulk of the policies they devised and implemented during their period of political hegemony (1860-1932).

[34] What follows draws on Weingast (1991).

Constitution, the three major antebellum political crises, and the Civil War and Reconstruction.[35]

Most citizens were deeply suspicious of the national government because of its potential to impose policies favored by other regions or interests. Early in the 19th century, prior to the rise of an integrated, interregional economy, the solution was simply for both North and South to agree to limit the federal government's authority, thus limiting the ability of either to impose its will on the other. Although the partisan debate involved the role of the federal government in the economy, the range of involvement was relatively circumscribed, for example, tariffs and internal improvements.

The principal institution providing durability to the agreement between the regions concerned the "balance rule" or the equal representation of the North and the South in the Senate. The balance rule afforded each region a veto over national policymaking. As I argue at length elsewhere, this had a profound effect on national politics (Weingast 1991; see also Roback 1992). The main implication for present purposes is that the set of concurrent vetoes prevented national policies that were considered especially inimical by either region. This institutional convention thus provided the political foundations for the preservation of a slave economy in the South, a free one in the North, and a limited national government.

As the economy became interregional, however, many policy questions were no longer so easily disaggregated. For example, should growth of interregional trade be subsidized by federal support for roads, canals, and, later, railroads? Should national and agrarian expansion be encouraged via low prices for federal land on the frontier? At about the same time, the Missouri crisis (1818-20) convinced Southerners that the national government's authority might be used against their "property" and their "institutions," i.e. against slavery (Carpenter 1930).

In response to these and other issues, the Jacksonians attempted to form a national political coalition to capture political power. They not only articulated a set of policy goals of limited federal government, but a constitutional jurisprudence to underpin these limits. Southerners, seeking to forestall any precedent expanding the scope of national authority,

[35] Other political divisions were also important, but for what follows, we concentrate on the former. For a discussion of the interaction of slavery and other issues during the period of the second party system being considered in the section, see Weingast (1991).

favored this view. The Jacksonian appeal was thus built on a set of principles which provided considerable security for slaveholders, helping this party secure majority support in the South and in the nation.

The Jacksonians implemented a policy of limited federal government via their dominance of national elections and hence control of policy at the national level.[36] Their electoral success critically depended upon the nature of their organization. Key to the Jacksonian's success were four principal instances of organizational conventions and practices that provided credibility to their views. First, the Jacksonians staked their reputation on their campaign promises. Given the centrality of slavery to the South, significant slippage between promise and implementation would clearly ruin the party's ability to compete in that region and thus, as all knew, its ability to maintain its majority position. Second, they articulated a constitutional jurisprudence of states' rights, keeping down precedents for increased national authority. As their Supreme Court appointments reflected these views, it led to compatible Constitutional decisions. Third, as part of their appeal to Southerners, they adopted the two-thirds rule for nominating candidates to the presidency (Potter 1976, Weingast 1991). This granted Southerners a veto over their party's presidential candidate, assuring them considerable influence not only over their party's candidate but — as the Democrats held the presidency in three-fourths of the Congresses between 1828 and 1860 — over the Presidents as well. Fourth, they were willing to maintain balance at the national level, assuring the South the ability to maintain its veto over national policy via its equal representation in the Senate.

This argument shows that not only did the Constitution provide the principle mechanisms of political decentralization inherent in federalism, but, because the majority party in the nation favored that position, it was maintained as both national policy and as Constitutional law. The majority party in the nation proved instrumental in translating a broad, national consensus for limited federal government into a series of institutions making those limits credible.

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[36] During the 16 Congresses between the elections of Jackson and Lincoln, the Democrats held all three national institutions in 9 of 16 Congresses, while the Whigs held all three only once. The Jacksonians also dominated Supreme Court appointments. From 1828 to 1860, 11 justices were appointed under united Democratic control, 2 under divided control, and none under Whig or Republican control. See Weingast (1991).

The argument in this section exhibits strong parallels with the approach developed in section 5. Underlying the limited role of the federal government was a national consensus that this was appropriate. Although no sovereign was relevant for the United States, a parallel problem existed between the two groups of citizens, namely, each worried that the other might come to dominate the national government, allowing it to use national power for its own regional purposes. Because the problem was symmetric, both sides agreed to limits on national authority as a means of limiting the ability of the other to dominate. This, in turn, required a combination of institutions and attitudes to succeed. The institutions ranged from federalism and the commerce clause discussed above, to the various attempts to provide regional balance in the national assemblies. These institutions, in turn, fundamentally rested on the attitudes and preferences of citizens: it required that the vast majority in the nation believe these agreements were appropriate. Problems emerged only at the end of the second party system when one party, the new Republicans, proved no longer willing to maintain these institutions, notably, the balance rule (Weingast 1991).

PART C: IMPLICATIONS FOR ECONOMIC REFORM

7. Reform in China and the Former Soviet Union

The contrast between the success of economic reform in southern China and the troubled path of reform in the former Soviet Union and its satellites is not only striking, but appears to reflect the lessons of this paper.

Beginning in the late 1970s, China embarked down a path of economic reform. Its success, at least in the south, has been remarkable. The *Economist*, for example, calls the province of Guangdong "Asia's fastest-growing economy over the past fifteen years" (March 28, 1992, p. 32). Initiated in the mid to late 1980s, reform in the former Soviet Union, its successor states, and its former satellites has proved considerably more problematic.

A range of factors have contributed to China's economic success relative to the former Soviet Union. For example, the proximity of South

China to foreign capital, notably family wealth of those who had previously fled the communists to Hong Kong or Taiwan; the relatively limited initial scope of economic reform, perhaps including its focus on agriculture while ignoring the large-scale public enterprises; and, in contrast to the former Soviet Union, its relatively shorter experience with communism, its leaders' greater pragmatic and less ideological pursuit of socialist economic principles, and an economy far less interdependent. Moreover, in contrast to the republics and satellites of the former Soviet Union which inherited a range of economic and fiscal problems from their former regimes, China initiated the reform process with relatively strong fiscal health. And because China's reforms were initiated over a decade ago, its reform has been given greater time to unfold and demonstrates its effects.

Undoubtedly most or all of these factors contributed to China's success. And yet these and related factors provide an inadequate understanding of China's success.

China. A central though underemphasized factor of China's reform is that it was initiated with political reform.[37] As part of the effort to pursue economic reform, the central authorities instituted a form of political decentralization that limited their own power. Importantly from the perspective of this paper, this decentralization produced a form of market-preserving federalism. Although it differs considerably from Western style federalism, China's political system approximates the four necessary characteristics of market-preserving federalism identified above.[38]

Key to China's economic success, the new decentralization affords local governments considerable discretion over economic policy. In many areas, officials have used this authority to create markets and entrepreneurial enterprises, and it is these areas that are experiencing the largest growth. The economic effects of the decentralization have been felt in the growing degree of entrepreneurialism found at the local level and the

[37] As applied to China, "political reform" usually refers to the process of democratization. The latter is clearly a central aspect of political reform, one of sufficient value that it receives special attention. Yet it reflects only one aspect of politics and of political reform. In what follows, we use the term in its broader sense.

[38] If there is an exception, it is presence of internal trade barriers. The economic costs of these provisions is unknown, and so much of the growth in China has occurred through the rise of its export economy.

growing participation of these enterprises in international markets (Nee 1992, Oi 1992, Rozelle 1992, Walder 1992).

Underpinning this success was the central government's seeming toleration of the loss of local political control over economic policymaking. This has had two effects. First, it has lowered the influence and importance of the relevant ministries of the central government and hence of central planning. Second, at the local level, although political officials nominally remained communist in many areas, their incentives changed dramatically. With the growing success of economic reform, local revenues came to depend on the economic health of the local economy, not upon political allegiance to the central government or conformity to a central plan. Paralleling the incentives facing the English Justices of the Peace during the industrial revolution, decentralization in China provided many local political officials with the incentives to create an economic and political environment fostering economic growth. In both 18th century England and modern China, prospering economic enterprises provide an expanding local resource base, aligning the interests of local officials with local economic success.

The loss of central government influence and control over local officials provides the answer to why the critical third condition of market-preserving federalism holds. The process by which the decentralization was initiated sheds considerable light on how durable limits on government are established. Decentralization was established by decree, and, initially, it had no special durability. Nonetheless, the degree of support among the central authorities, notably Deng Xiaoping, led to a range of experiments, emphasizing aspects that could be changed in the short run and that did not leave long-term investments vulnerable. As these proved successful, and the central government did not revoke them, they were expanded and imitated. As the process continued, local incentives changed continuously from those emphasizing allegiance and control by the central authorities to those reflecting local economic prosperity. Thus the durability of the reforms did not arise all at once but grew as the degree of economic success improved.

The loss of control directly limits the ability of central authorities to intervene adversely in these new markets. Short of using the army — still under national control and therefore potentially a factor in the future — the central government no longer appears to have the ability to reverse its political and hence economic reform efforts.

The Chinese Government's failed effort to halt or reverse the economic reform process after Tiananmen Square demonstrates the degree of durability to the political reforms. Three aspects of the reaction contributed to the undoing of the Government's attempted reversal. First, many areas of the economy began to decline, raising fears of unemployment and vast new fiscal problems for the central Government. Second, as part of the Government's campaign, it attempted to promote the large state-owned enterprises. This effort not only failed to produce results but had significant, negative fiscal consequences. Third, the economic retrenchment was resisted by the local officials all across the areas experiencing the highest economic growth, officials who had no interest in seeing the retrenchment succeed. The retrenchment attempt proved sufficiently difficult that the Chinese Government gave it up. Its abandonment revealed that the Government was unwilling to pay the price of reversing the reforms. Barring extreme events, the reforms have become a central component of modern China.

The abandonment of retrenchment, in turn, removed a degree of uncertainty about the durability of the reforms and hence a degree of the political risk associated with them. Growth rates since the abandonment have been over 20% per year in some areas, consistent with the view that removing a degree of political risk increased expected economic returns, thus enhancing the willingness of entrepreneurs and investors to undertake actions promoting growth.[39]

A number of important qualifications to China's economic success must be raised. The first concerns the extensive and growing problem of the state enterprises (Wong 1991). China's strategy for economic reform put off dealing with these enterprises until later, thus leaving them (and their large state subsidies) largely untouched by the reforms. These enterprises represent a growing burden for the central Government, and may prove the undoing of China's economic reform. Or perhaps dealing with these enterprises in a later phase of reform will prove easier than attempting to transform them during the initial reform phase. Second,

[39] The *Economist*. Similarly, since early 1992, Hong Kong has experienced a new optimism. The increasing ties of Hong Kong's economy to that of South China is one factor contributing to the durability Hong Kong. Unfortunately, as recent events remind us, it is not the only factor.

decentralization of power has not been uniform, in part explaining why reform has not been uniform across regions. Third, considerable internal trade barriers remain across regions, including barriers to labor migration. Many local officials have taken advantage of political decentralization to protect local enterprises. Fourth, a large number of tasks of economic reform emphasized by economists have yet to be tackled (e.g., a law of commerce or credit). The mechanisms for enforcing long-term agreements with sources of foreign capital remain underdeveloped. Finally, given the critical role of aging octogenarians underpinning the reform effort, uncertainty over the succession implies a degree of political risk. Although at this time it seems unlikely that a hardliner will gain power, it remains possible. That event could lead to a central Government willing to pay a higher price to contain or reverse the reforms. These considerations, at the very least, limit the degree of China's reform success, i.e., the degree to which they can capture the gains from national and international specialization.

Eastern Europe and the former Soviet Union. In an important sense, governmental authorities in the emerging states of the former Soviet Union and its satellites have taken the opposite strategy from that of China. In contrast to China's initiation of reform by providing a secure political foundation to economic change, reform in Eastern Europe has emphasized the central design of a new economic system, to various degrees attempting a wholesale conversion of these economies to free markets. Although there has been considerable attention to political reform and the design of democratic institutions, the central problem of limiting the government's potential intervention in economic affairs seems to be being ignored. Market reform is taking place in the absence of an attempt to design political institutions to sustain it. As a consequence, there is no credible commitment by the state to markets.

Consider the case of reform in Soviet Union under Gorbachev. Although the Soviet government decreed a variety of reform policies in its last five years, little attention was paid to the problem of durability or limited government (Boettke 1993, Litwack 1991). In 1987, for example, Gorbachev announced a set of reforms designed in part to stabilize taxes for five years (e.g., the set of decrees known as the "Law of State Enterprise"). Unfortunately, the new tax code was revised within six months and regularly thereafter. As Litwack argues, the absence of durability to these reforms implied that enterprises could not rely on any aspect of the current system of regulations and laws.[40] These were therefore not "laws" in the sense meant in the West. Because tomorrow's decree can reverse today's, an economic system based solely on a set of decrees fails to provide a secure political foundation.

This is clearly illustrated by the course of reforms under Gorbachev. When the former Soviet Union experienced unanticipated revenue problems, it was precisely those enterprises with some success that were the target of the state's rapacious need for new taxes (McKinnon 1991). In the face of a decline in state revenue — in part due to the decline in the state sector and in part to the revenue implications of the reforms themselves (McKinnon 1991) — the "Soviet leadership [responded] . . . by making discretionary changes in tax laws, including the introduction of a very harsh 'emergency measures' since 1989 to absorb surpluses from profitable organizations." (Litwack, 1991, p. 87).

This behavior, of course, is precisely what generates the equilibrium trap noted above. Instead of providing a secure political basis for economic reform, this environment yielded political unpredictability and political risk. Consistent with this view, economic reform in the Soviet Union failed to result in economic growth. Instead, it experienced economic turmoil and decline, ultimately leading to the Union's extinction when it could not meet its financial obligations. This conclusion is supported by Boettke's investigation of the failure of Perestroika:

> without [a] commitment to protect the legal rights of the private sector, there was no way to induce the investment and hard work that were needed to develop the Soviet economy. . . The inability to convey any kind of commitment to reform sealed perestroika's fate. (Boettke 1993, p. 103)

In contrast to the Chinese Government, Gorbachev did not attempt to provide political durability to his reforms, instead choosing to retain political discretion.

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[40] " . . . despite the plethora of recent laws, the Soviet leadership has made no progress in establishing economic legality. . . Virtually every law, for example, that has promised stable taxation to eliminate *uravnilovka* [the equalization of profit] and make profit incentives operable has been overtly violated or revoked to the preservation of the discretionary expropriations." (Litwack, 1991, pp 86-7.)

Like his economic reforms, Gorbachev's political reforms also failed. Gorbachev's proposal to reconfigure the Union as a confederation, for example, paid little attention to the problem of credibility. Unlike the Chinese central government, Gorbachev proved unwilling to engineer credible limits on the Union's authority. As long as the central authorities retained control over the vast Soviet army, any restrictions in a confederation agreement would have the status of promises — promises that could be broken at the whim of one of the parties to the agreement. Gorbachev's proposals therefore would not have created more than a parchment barrier confining the Confederation's actions. Before and after the August 1991 Coup, he made little attempt to deal with this dimension of reform, and his negotiation partners proved unwilling to accept his proposals.

The new Russian government under Yeltsin has continued in the same vein, though with some critical differences. With respect to the differences, it has not only articulated a greater political dedication to economic reform than that of the Union under Gorbachev, but it has more consistently pursued its implementation.[41] Yet it too has failed to address the problem of durability and limited government. It has instead maintained its discretion to deal with problems and unforseen events.[42] This discretion inevitably implies a degree of political risk. Worse still, as the future of the regime remains in doubt, there can be little durability to its economic policies, thus greatly limiting the extent to which entrepreneurs will commit resources to long-term investments whose

[41] Obviously, the uncertainty over the future of this course has increased based on the political events at the end of 1992.

[42] Because Russia has yet to rewrite its constitution, we cannot directly assess the degree to which it will protect individual rights. We can evaluate the new constitutions of the former Soviet Union's satellites, however. Although some contain provisions protecting individual rights, other provisions allow the state to violate them if an important state interest requires it. Siegan (1992, p. 44) reports that although the recent Czech and Slovak charter provided that the "sanctity of the home is inviolable," it may be interfered with "if it is essential in a democratic state for protecting the life or health of individuals, for protecting the rights and freedoms of others, or for averting a serious threat to public security and order." As long as the government itself interprets the meaning of these provisions — and in the absence of a strong tradition of an independent judiciary to do so — the latter qualification effectively nullifies the former provision. Moreover, similar provisions appear to qualify a large range of private and individual rights.

success depends on a particular specification of rights, tax rates and other policies.

Implications

Definitive judgements about the relative success of reform in China and the former Soviet Union clearly await further developments and more evidence. Yet the mid-term report reveals some lessons that, if upheld under further scrutiny, are striking. On the one hand, the former Soviet Union and its satellites have chosen the path of reform suggested by economic orthodoxy. Political reform has meant a dismantling of the old system and, to varying degrees, an attempt to institute some form of democracy and representations. By and large, it has ignored the problem of creating limits on government and hence of providing market reform with long-run durability.

On the other, China ignored that orthodoxy and instead began with a political reform instituting a form of market-preserving federalism. It did not begin with a centralized attempt to redesign the economy. Nor have efforts been made, except on a local basis, to develop a comprehensive system of property rights, commercial law, etc.

Importantly, China appears far more successful than the former Soviet Union and its successor states. This contrast suggests that securing the political basis of economic reform may be as important or more important than ensuring the appropriately designed economic system. This is not to say that China's strategy is optimal or that the redesign of the economic system is unnecessary — far from it. Its present political arrangement lacks the ability to provide aspects of the economic environment that are national public goods, e.g., commercial and contract law or a system of private property rights. This section has instead emphasized that political and economic reform are complementary undertakings and that attention to securing the political foundations of economic reform at the same time as redesigning an economy may foster greater economic success than attention to the latter alone.

8. Conclusions and Lessons for Today

The main lesson for contemporary developmental and economic reform problems is that the benevolent attitude of the government cannot be taken for granted. Markets require protection and thus a government strong enough to prevent itself from intervening, specifically, from reacting to the inevitable political forces that arise to support intervention. The fundamental political dilemma of an economic system is that a state strong enough to protect private markets is strong enough to confiscate the wealth of its citizens. The dilemma implies that attention must be given to the question of what guides the state down the former path. As North (1992, 2) argues:

> Throughout most of history and in much of the present world, institutions have not provided the credible commitment necessary for the development of low cost transacting in capital and other markets. There is, therefore, little evidence to support the view (apparently implicitly held by many economists doctoring the ailing economies of central and eastern Europe) that the necessary institutions will be the automatic outcome of getting the prices right through elimination of price and exchange controls.

Put simply, the political foundations of markets are as essential to their success as the details and specification of the market itself. This implies that markets and limited government are complementary aspects of economic development and reform; each enhances the value of the other. Political development must therefore take place simultaneously with and along side of economic development.

In contrast, recommendations of many economists focusing on the price system seem to assume that the process of economic development and political development may be sequenced: that a stable, democratic regime is most likely to emerge and survive in the wake of successful economic reform. The perspective developed in this paper suggests that this assumption is incorrect: Because these two processes are complementary, successful economic reform is significantly less likely to occur in the absence of political reform.

The complementarity of economic and political development provides for the role of the constitution. By placing an appropriate set of constraints on the state, a constitution can limit the state's actions in desirable ways. Yet the possibility of beneficial limits does not imply they are automatically realized. Rather, it forces us to ask what makes those limits credible, that is, what makes them binding on political actors? To address this question, this paper examined how England and the United States grappled with these problems in the past. Although a range of considerations played important roles, this paper focused on the institution of market-preserving federalism, a central factor in the economic development of both nations.

Several facets of federalism account for its success in England and the United States. First, it provided the political basis for the common market. Second, the prohibitions on the national government from economic regulation greatly reduced the political responsiveness to older economic interests who were displaced by an evolving economy. Third, the prohibitions on internal trade barriers allowed entrepreneurs, new enterprises, and new economic activities to emerge in new areas that could out-compete interests in older areas. In England, these factors provided the political foundation for the success of the industrial revolution. In the United States, they fostered first regional and then international specialization, underpinning American economic growth.[43] By creating credible restrictions on governmental policy choice, federalism provided the basis for the rule of law and hence the political underpinnings of economic freedom.

Yet what made these restrictions credible, what made them binding in practice? Though the details differ considerably, both cases reveal that federalism's success in practice relied on a mix of formal and informal constraints. As North (1992, 19) emphasizes, it is not only the institutions of society that help provide for secure rights, but also "the mediating influence of informal norms [that] constrain the behavior of the players at numerous margins." It is this mix of formal institutions and informal norms that I now wish to stress, for the first two points received considerable emphasis above.

The critical feature for England and the United States is that the success of constitutional constraints promoting the rule of law depended on the emergence of a social consensus about the appropriate limits of the state. Holding the state to prescribed limits does not depend on a constraint being explicit, nor that it might have been agreed upon at some time in the past. It instead depends on how citizens react to a potential violation of that constraint. The ultimate sanction upon a government is

[43] As Casella and Frey (1992) argue, "If private economic decisions are influenced by public goods, . . . as we expect them to be, then markets and institutions should develop together."

the withdrawal of support by a sufficient portion of its citizens so that the government cannot survive.

The failure of this form of citizen reaction allows a host of constitutional violations in Latin America and other parts of the third world (see, e.g., Montinola's 1992 discussion of Marcos's rejection of the Philippine Constitution). Notice, in contrast, the reaction to President Franklin Roosevelt's famous court packing scheme. Although proposed at a time of unprecedented political support for Roosevelt and the New Deal and although it was an institutional change clearly designed to benefit his constituents, it was deemed illegitimate by a sufficient number of his supporters that its future was highly questionable.[44]

For both England and the United States, the decentralization of political authority implied by market-preserving federalism was the product of a historical process resulting in a strong consensus supporting these limits. The English state's failure to respect citizen rights in the late 17th century led not only to the Glorious Revolution, but to a new consensus about the appropriate limits on the national government's authority. Constructed through negotiations in Parliament among the leaders of the various factions in society, the consensus over limits were embodied in a new set of constitutional arrangements, including the increased reliance on the common law courts rather than royal discretion, the increased attention to the security of property rights, and concern for the maintenance of local political authority, especially in matters of economic control and regulation. These arrangements at once created the political decentralization necessary to support market-preserving federalism and the national consensus to provide it with durability.

During the first 150 years of the United States, the foundations of market-preserving federalism rested on the fact that the vast majority of the population consistently favored policies and parties providing for a limited federal government and for the protection of economic rights. The two breakdowns of this consensus underscore its role and importance. The first concerned the role of the federal government with respect to slavery and resulted in a civil war. The second — and permanent — breakdown occurred during the Great Depression. At that time, a new political

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[44] Roosevelt did not pursue this scheme for several reasons, most notably that the Supreme Court itself reversed direction in early 1937. For a recent review, see Gely and Spiller (1992).

majority emerged. It not only sought to expand the national government beyond the traditional limits of the Constitution, but engineered a reinterpretation of the key constitutional constraints. Within five years, the principal constitutional constraints of market-preserving federalism were removed (see Weingast 1992a).

The comparison of economic reform in the former Soviet Union and in China emphasized the importance of the economic role of political institutions. The problems faced by these two states are very different, and hence strong conclusions cannot be drawn from a brief comparison between them.[45] Nonetheless it is striking to note not only the enormous difference in the approaches to reform, but their relative success. The former Soviet Union began by concentrating on its economic system, retaining strong discretionary powers for the government. No attempt was made to establish limited government or to tie the government's hands with respect to future economic policy. While there has been some attempt to institute political rights and democracy, these limits on the government do not as yet extend to economic rights or the basic structure of the economic system.

In contrast, China began with a political reform in which the central authorities, while not completely binding their hands, made it much harder for them to use those hands. The Central Government limited itself by giving away power to local authorities in a way that would be difficult — and which recently proved difficult — to retake. This, in turn, set the stage for a series of economic transformations across much of China. For local governments, political freedom and political protection from the central state combined with economic opportunities to provide strong incentives to foster and protect markets. The success of some regions is nothing less than remarkable.

Lessons for today

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[45] E.g., as Offe (1991) observes, the states of Eastern Europe and the former Soviet Union face many problems of transition simultaneously: (a) territorial integrity, nationalities cannot be taken for granted; (b) relations between citizen and the state are under redefinition, i.e., not only is the form of government changing, but so too is "the legal relationship between the state and society" (democratization); (c) market reform per se. In contrast, China could concentrate primarily on (c).

The view developed in this paper reveals the inadequacy of recent advice to the emerging democracies of Eastern Europe and the former Soviet Union. First that of economists, focusing on constructing market mechanisms, provides an incomplete basis for building the critical political foundations for economic success. Economists have, by and large, ignored the necessity of establishing limited government, assuming that the lion's share of the problem is the adoption of policies creating markets. Because the latter fails to commit the state to respect markets in the future, it fails to provide the necessary political underpinnings for markets to prosper. That can only be accomplished by political reform which takes place along with the adoption of markets and that provides for limits on the future discretion of the state.

Second, democratic theorists, focusing on creating public sector responsiveness to majorities, ignore problems created by future political discretion. Like the economists, these scholars ignore the need for institutions to limit the ability of the political system to respond to the whims of future majorities, potentially destroying nascent markets. As noted above, an essential aspect of successful economic development is the establishment of the rule of law, a society of "laws not men." And yet, as we have seen, ensuring democratic responsiveness alone is not enough. Democratic regimes can also violate the rule of law by acting opportunistically ex post. Although democratic responsiveness is an important aspect of limited government, it alone does not ensure limited government.

For the emerging democracies of Eastern Europe and the former Soviet Union, this suggests that redesigning economic and political institutions should be attempted simultaneously. In particular, these institutions need to be consistent with one another. What economic incentives are implied by the degree of discretion afforded the government under the political institutions? Are they compatible with secure property rights and the development of the rule of law?

Russia. The approach emphasizes the importance of a new constitution to underpin economic reform. It suggests that designing a new constitution ought to be a priority along with marketization, and these two processes should occur simultaneously. A new constitution is needed to help promote the constraints supporting limited government underpinning a market so that the rights so necessary to maintain a thriving market have some security.

Nonetheless there are political tradeoffs, as is easily seen from an examination of Yeltsin's dilemma in Russia. A new constitution establishing limited government will constrain Yeltsin in comparison with his relatively free hand to engineer reform by decree under the current system. Such a constitution will undoubtedly impose additional political constraints on the policymaking process, forcing Yeltsin to negotiate his program with a broader set of political leaders and hence a broader coalition. The current system has its constraints as well, and in the final months of 1992, these not only became more apparent, but have resulted in explicit limits on the reform process. By providing an increase in longer-term security, a new constitution of limited government will endow the reforms with a degree of durability. Because they are more likely to survive Yeltsin, reforms backed by a constitution lowers political risk. This, in turn, will raise the private returns to economic investment and entrepreneurial activity, thereby boosting the prospects of economic growth.

To have this effect, however, the constitution must be endowed with a degree of social legitimacy. This requires that a large portion of the citizenry value it, that is, that large numbers of Russian citizens see it as the appropriate set of political, economic, and social relations to guide them in the future. Only a constitution of this form has a hope of constraining anti-reformists and reactionaries. It cannot prevent such a reaction against reform, especially if the reactionary regime proves willing to use the army. Nonetheless, to the extent that the constitution is seen as appropriate by the vast majority of citizens, it raises the price such a regime must pay to carry out a reaction, thereby making a reaction less likely.

How is such a constitution to be devised? Two elements are essential (as Ackerman 1992 has observed). First, endowing the constitution with a degree of democratic legitimacy is crucial. This calls for a national referendum on the constitution and an immediate set of elections to fill the elected positions thereby defined. It also calls for the government to promote constitution norms in parallel with the promotion of its program of economic reform. Second, timing is essential. Perhaps the best moment to produce a new constitution is early in the new regime's tenure when there is still considerable hope and optimism. These circumstances make it more likely that a constitutional document is endowed with a special standing among the citizenry.[46]

This approach reveals why the ad hoc and piecemeal revision of the old constitution inherited from the communists utterly fails at the task of creating legitimacy. First, that constitution is an object of opprobrium, not value or legitimacy. Second, because it holds no special, positive status in the value systems of citizens, there is no reason for citizens to defend it. Third, the piecemeal nature of the revisions imply that some portions ought to be valued and others not. These conditions generate exactly the problem a constitution was designed to resolve, namely the ambiguity about the appropriate limits on government. Piecemeal revisions imply that it is highly unlikely that citizens will agree about what parts of the constitution must be defended. Transgressions by the government are therefore not likely to be policed. In comparison with a democratically chosen constitution designed to usher in the new era and to protect citizen rights, a patchwork set of revisions to the inherited communist constitution will stir considerably less social reaction when a provision is altered or violated. Because such reactions are one of the few ways to police limits on the state, a constitution must reflect a consensus about those limits.

Thus, Yeltsin's delay in attending to this task has made it harder. Much less optimism currently surrounds the regime and its program of reform, and it is clearer who the losers are under the program. As a consequence, there is likely to be less support for a constitution underpinning limited government.

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[46] Ackerman (1992:xx) also calls for a constitutional convention whose delegates are elected. Because we know too little about the conditions under which a workable constitution emerges, I am not convinced about this condition. The advantage to it is that it presumably endows the end product with additional legitimacy. The disadvantage is that it makes it less likely that a coherent and workable document is produced (Riker 1987). Moreover, the two conventions used by Ackerman to support his views — those producing the United States Constitutional and West Germany's Basic Law — worked under special conditions that cannot be expected to hold in general. In the first instance, the main opposition, the Anti-federalists, chose to boycott the convention in an attempt to deny the result with legitimacy (Riker 1987). Had they attended, an altogether different document would have been produced, and it is hard to imagine that something as coherent — or as successful — would have emerged. In the second case, the Allied occupation implied that only a limited set of constitutional principles would have proved sufficiently satisfactory to have induced them to turn power back to the Germans.

Finally, prospects for the beneficial effects of market-preserving federalism seem bright not only in Russia, but in the Confederation of Independent States (CIS). For the former, why should the lion's share of reform be directed at the center? Why not create the right of regions and major cities to establish their own economic policies, subject to the constraint that they cannot restrain internal trade?[47] This would allow a range of experiments as the different zones attempt to devise rules and foster enterprises suited to the new environment. Competition among zones would allow successful experiments to expand and prosper. This not only increases the chances that parts of the reform effort will succeed, but will lead to the imitation of the successful zones by others. Similarly, at the level of the CIS, emphasis should be placed on establishing a common market with minimal trade barriers.

The role of external actors. External actors such as the European Community (EC), the United States Agency for International Development, and the International Monetary Fund may potentially influence these processes.

With respect to economic reform, external actors appear to be content with political reform that dismantles the old communist regime and which provides for some degree of democratization. The perspective of this paper suggests adding an additional step: The construction of a constitution of limited government should be a priority along with that of marketization. Value should also be placed on actions promoting the legitimacy of the new constitution among the citizenry and on the government adhering to it once it is adopted.

Another important set of external actors are nearby states. With the exception of West Germany's absorption of the East, the EC and its members have emphasized rhetoric over substance. Because they are wary of fostering the economic development of competitors, they have kept their markets closed. The effects on the states in transition are twofold. First and most obvious this limits economic growth in the reforming economies. Second, it changes the stakes of the domestic political game. By lowering the prospects for growth of Eastern economies, limiting access makes reform less valuable and hence less likely to withstand domestic political pressures. In contrast, the opening of EC markets would foster the

[47] Some cities in Russia such as St. Petersburg have begun to do so. However, these reform efforts reflect an ad hoc rather than institutionalized basis.

transition states' success in achieving stable democracies and growing economies.

In sum, though definitive conclusions cannot be made, I have argued that securing the political foundations of markets must be accomplished at the same time and is equal in importance to the development of markets and "getting prices right." The historical evidence supports this position (North 1981, 1992). The comparison between China and the former Soviet Union further suggests that limited government appears to be an important component of economic reform. This emphasizes the critical *economic* role for *political* institutions — to provide the appropriate foundations to economic policymaking and a secure system of economic and political rights.

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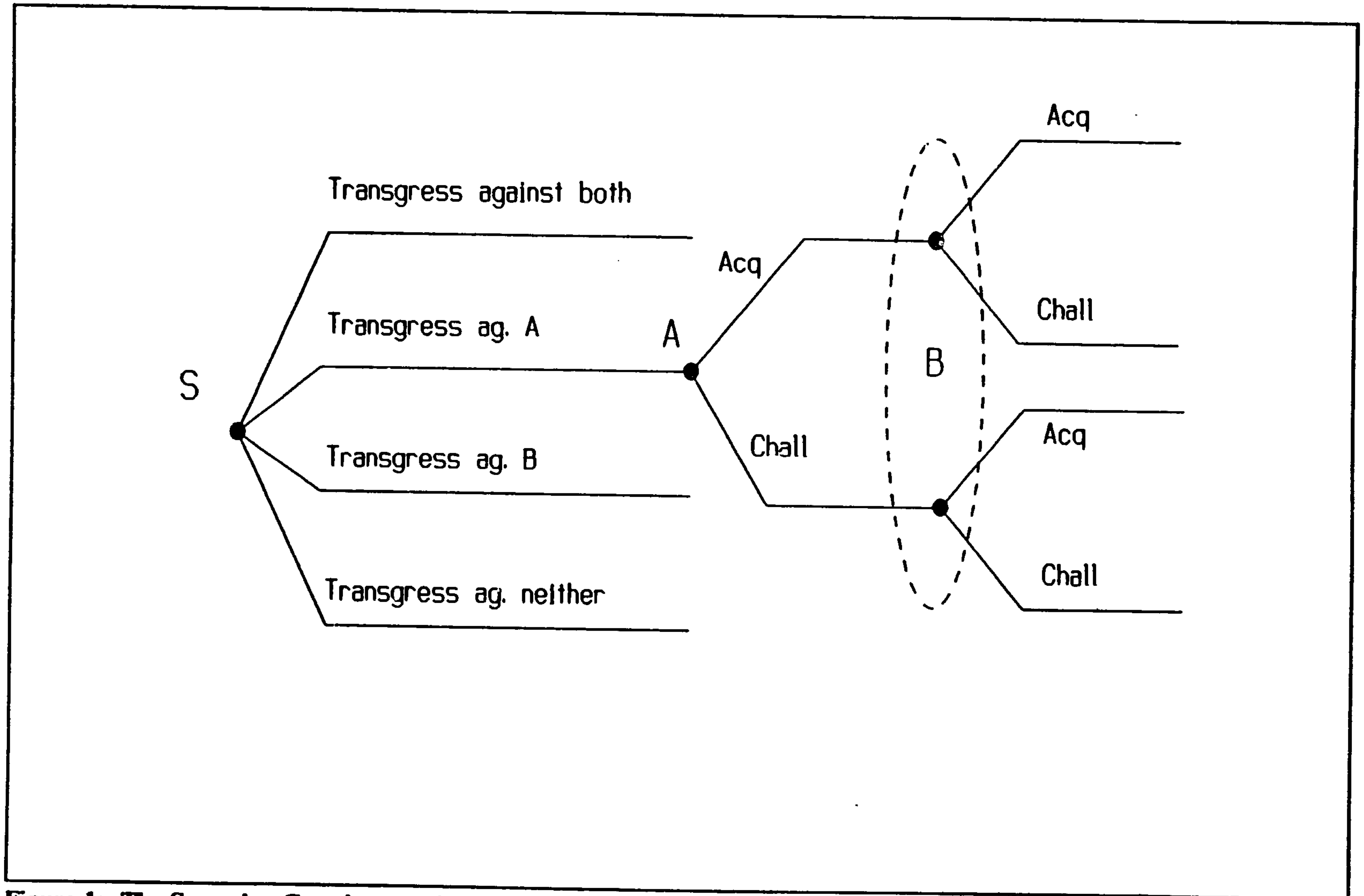

Figure 1: The Sovereign-Constituency Transgression Game.

5

Table 1: Payoffs for the Sovereign-Constituency Transgression Game.

S Chooses	A	B: acq	B: chall
Transgress against both	acq	5, 1, 1	5, 1, 0
	chall	5, 0, 1	0, 3, 3
Transgress against A	acq	3, 1, 4	3, 1, 3
	chall	3, 0, 4	0, 3, 3
Transgress against B	acq	3, 4, 1	3, 4, 0
	chall	3, 3, 1	0, 3, 3
Transgress against neither	acq	1, 4, 4	1, 4, 3
	chall	1, 3, 4	0, 3, 3

Induced subgame between A&B (payoffs: S,A,B)