

## ECONOMIC GOVERNANCE – AN OVERVIEW

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### Economic Governance:

Concept jumped from unknown to ubiquitous. Number of occurrences in Econ Lit:  
1970-79: 5; 1980-89: 112; 1990-99: 3,825; 2000-05: 7,948.

What is it? General definition: Processes that support economic activity and economic transactions by protecting property rights, enforcing contracts, and taking collective action to provide appropriate physical and organizational infrastructure.

Distinct from corporate governance – various agency problems to do with corporations (shareholders v. managers, hierarchy of management) and their resolution by explicit or implicit contracts, incentive schemes etc. But the two are connected because the boundary of a firm is itself endogenous (Coase, Williamson).

### Institutions of Governance:

Formal – Constitution, legislation, policing, courts, ...

Informal – Social networks for search and information, norms and sanctions for enforcement

Private adjudication and enforcement (non-profit or for-profit)

Informal ones most frequent in LDCs, transition economies

Interaction of informal with formal, and transition to formal, are the key issues

## ISSUES AND TAXONOMIES

### CATEGORIES OF ECONOMIC SITUATIONS & TRANSACTIONS NEEDING GOVERNANCE

- a. **Predation:** One-sided, involuntary. Pertains mostly to property rights.  
Not just theft but other violations of property rights, especially intellectual property.  
Special problem – government or its agents may themselves be the predators
- b. **Mutual insurance and gift-exchange:**  
Transfer in one direction at one time, with non-specific obligation to reciprocate  
These are hardest to govern; need one party to have authority and reputation  
Example – Don Corleone’s gift to the undertaker
- c. **Borrowing and lending, selling for delayed payment, selling experience goods:**  
Transfer occurs in one direction at one time, with specific obligation to reciprocate.  
This is the classic one-sided prisoner’s dilemma – Hobbes, Williamson, Greif etc.
- d. **Trade, exchange of goods or services for other goods or services or money:**  
Transfer in both directions, so two-sided prisoners' dilemma, matched from population  
Exists in all economic transactions except purely spot exchanges  
Example – Gambetta’s cattle rancher and butcher
- e. **Contribution to provision of public goods, or preservation of common property resources:**  
Multi-person prisoners’ dilemmas. Examples – Ostrom’s case studies

### COMMENTS

Taxonomies are conceptual categories to help analysis. In reality the categories blur, overlap  
Differences between property right protection and contract enforcement - [1] involuntary versus voluntary “transaction”, [2] stock versus flow (not always; contracts can be about stocks).

## CATEGORIES OF INSTITUTIONS OR MECHANISMS OF GOVERNANCE

### 1. First-party

Operating on potential miscreant's own value system to induce good choice of action

Norms of behavior where the reward to compliance or punishment for deviation are internalized by individuals, or instilled by society into them during education or socialization.

These can be moral or social imperatives. S-C Kolm's useful distinction - if after violating the norm you feel guilty, that is moral; if you feel ashamed, that is social.

### 2. Second-party

Bilateral and multilateral methods of communication and punishment

Bilateral best, so parties try to develop relationships, invest in reputation etc.

Multilateral – others in group inflict punishment on behalf of previous victim

Problems of communication and action can both have public good problems

### 3. Third-party

Converts one-shot game of two parties into repeated game of each with the third party

Subcategories

(i) Provision of information that then becomes an input to second-party enforcement

Examples: Credit and quality certification agencies. Gambetta's Don Peppe.

(s) Private adjudication and enforcement under the shadow of formal law

(e) Direct enforcement for profit by the third party. Gambetta's Don Peppe.

(g) Enforcement by governmental or quasi-governmental bodies.

Again there can be ambiguities and overlaps.

## COMMENTS

[1] Groups may **restrict membership** to those ethnically or socially similar. This could be regarded as an ex-ante precautionary device. This has downside, e.g. **market fragmentation**.

[2] The most successful enforcement systems **work by deterrence; don't need to actually use their enforcement methods (violence etc)** at all. Just need to establish advance reputation. So can't judge effectiveness by how often the punishment was inflicted.

In each instance, **compliance incentives can be mixture of positive and negative** – carrots and sticks. Mechanism or institution that can credibly promise better rewards or credibly threaten harsher punishments can achieve better outcomes. Examples: [1] Religion-based mechanisms can have both. [2] Organized crime may have advantage in latter respect. But can misuse it – "protectors overstay welcome" (Gambetta p.198). [3] Industry groups that also have social connections may be able to use the threat of social ostracism.

There can be **synergies / strategic complementarities / economies of scope between enforcement activities and other activities** including direct participation in the economic process or transaction involved. For example: [1] Groups can combine multiple roles – better technology of matching and of subsequent enforcement. Specialized information enables better enforcement – arbitration by industry specialists. [2] Gambetta says (p.19) that the main business of the mafia is protection; if it gets involved in the activity itself, that is just vertical integration. But that may be a natural consequence - the mafia may lower transaction costs by vertical integration. Examples from Repetto (p.163-4) – US mafia was able to lend to risky garment industry because it had better debt-collection methods than banks. And in construction and other industries, it was able to cartelize the producers, unionize the workers, and take its cut from both sides.

## A SMALL SAMPLE OF CASE STUDIES, AND THEIR RELATION TO THEORETICAL MODELS

Classified (again this is not always exclusive or exhaustive) using two tags:

a, b, c, d or e for type of transaction; 1, 2, 3(l, s, e or g) for type of enforcement

Page	Context	Authors	Trans.Type	Enfo.Type
6	Origins of Sicilian mafia	Bandiera	a	3(e)
7	Sicilian mafia	Gambetta	c, d	3(i, e)
8	American mafia	Repetto	a, b, c, d	1, 2
9	Cattle ranchers	Ellickson	a	2
10	Taxi drivers	Gambetta-Hamill	a, c	2
11	Maghribi traders	Greif	c	2
11	Genoese traders	Greif	c	3
12	Community Responsibility	Greif	c, d	3(i,g)
13	Merchant guilds	Greif-Milgrom-Weingast	a	2
14	Private	Milgrom-North-Weingast	d	3(s,g)
15	Diamond, cotton trades	Bernstein	c, d	2(p)
16	Collective action	Ostrom and coauthors	e	1, 2, 3(s,g)

## SUMMARIES EMPHASIZING POINTS RELEVANT IN CURRENT CONTEXT

Oriana Bandiera, “Land reform, the market for protection, and the origins of the Sicilian Mafia: Theory and Evidence”, *Journal of Law, Economics, and Organization* 19 (2003), 218-244.

Under feudalism, large landowning barons kept armies to protect their lands and peasants

Bourbons abolished feudalism; peasants acquired individual rights to smaller properties

Public protection poor after Bourbons; Italian state slow and ineffective

Peasants often lived away from land and had other jobs

Banditry increased, esp. cattle rustling, and esp. in period of economic decline / unemployment

Landowners started to hire as guards [1] those who were formerly guards for feudal lords,

[2] “the best and most violent bandits”

Initially the guards were not organized, but gradually formed groups

So mafia initially arose to protect property when the state could not

Purpose at least partly precautionary – widespread knowledge that a property was

protected by the mafia acted as a deterrent to potential robbers

So needed reputation more than actual exercise of violence

This created a negative externality – when one property is protected,

other unprotected properties are at greater risk.

Suboptimal Nash equilibrium; more mafia activity when land more fragmented

Optimal for the mafia to tolerate some theft as that increases demand for their services

Diego Gambetta, *The Sicilian Mafia*, Harvard U. Press, 1993.

1. The mafia's primary business is protection of its customers' economic activities. It may engage in businesses that it also protects, but this is just vertical integration.
2. **Serves niches where government does not enforce contracts** – informal sector to evade tax, illegal transactions etc. Mafias emerge during periods where state is absent or weak (similar observations in Japan, Russia).
3. **It serves both sides of the market.** People use its services voluntarily, and "purchase protection against themselves", so give hostages in Schelling-Williamson sense.
4. Two types of service – **information about prospective partners, punishment of cheating partners.** Higher fee for latter. Violence more likely with providers of guarantees, and an internecine fights for territory etc.
5. The business of protection is **generally conducive to a monopoly or oligopoly.** Multiple providers will try to carve out exclusive territories.
6. When insiders are well-defined, outsiders can be ripped off with impunity. Thus free-riding is avoided.
7. **Mafioso's honesty is not automatic.** So problems of extortion and double-crossing. Need sufficient bilateral repetition between mafioso and each customer.

Thomas Repetto, *The American Mafia: A History of Its Rise to Power*, New York: Holt, 2004.

Late 19<sup>th</sup>, early 20<sup>th</sup> centuries: Entered activities that were illegal at the time – gambling, counterfeit currency, drugs, prostitution. Also extortion of local merchants. In 1920s, liquor. Then expansion of other activities, also infiltrated legitimate businesses by lending, cartelization, “protection.” By 1960s moved to less vertical integration, more purely enforcement activity – Skaperdas Econ. Gov. 2001  
So history opposite of that of Sicilian mafia as recounted by Gambetta.  
In turn, bought their own protection from political leaders and judiciary

Examples:

[1] Garment industry – Consists of small workshops with little capital, fierce competition, rapidly changing fashion. So too risky for banks to lend. Mafia was seeking uses for its prohibition wealth. Had better methods of collecting debts, both from and behalf of their clients. Could also cartelize. So they actively reduced the risk.

[2] Trucking, docks, construction, movies, fish market – Helped employers cartelize, break strikes. OR / AND Helped workers unionize, organize strikes. Took payoffs or percentages from one or both sides. These industries depend on timely delivery of product, so vulnerable to threats of disruption.

Started out as purely local gangs with very loose personal connections across them  
Admission/selection and initiation procedures can internalize group values of loyalty, silence etc.  
Gradually developed a somewhat tighter nationwide oligopolistic structure  
Violence mostly internecine warfare over territories

Robert Ellickson, *Order Without Law: How Neighbors Settle Disputes*. Harvard U. Press, 1991.

Property right enforcement among cattle ranchers in a small area of northern California

Use ongoing interactions over many dimensions, keep track of balance of credits and debits

A deviant is given an opportunity to make restitution

Failing that, news about his misdeeds is spread through the gossip network

Against persistent offenders, victims are allowed limited retaliatory "self-help"

(retaliatory destruction may be better than seizing that property –  
reduces incentives to allege damage falsely)

Finely graduated punishments, start low and ratchet up if misbehavior continues

Opposite of the grim trigger strategies in game theory.

Only in the most extreme cases is formal law invoked

Deviants are more likely to be newcomers.

Conflicts more likely when technology changes

Diego Gambetta and Heather Hamill, *Streetwise: How Taxi Drivers Establish Customers' Trustworthiness*. Russell Sage Foundation, 2005.

Taxi drivers face risks of non-payment, robbery, carjacking,  
and in Belfast sectarian violence

They must read signs to try to distinguish genuine paying customers  
from potential cheaters or robbers

But the cheaters / robbers will try to mimic genuine customers' appearance and behavior

Must look, not for any single indicator, but for multiple indicators,

such that it would be infeasible or too costly for a malefactor to mimic them all

Most important revelation often comes from involuntary microexpressions

that the customer cannot perfectly control; hence important of trained instinct  
in spotting these. See also Malcolm Gladwell's book *Blink*

Spence calls these "indexes" as opposed to "signals"

Drivers' information networks and guidance to newcomers

Special feature – protection is almost entirely by ex ante precautions,  
very little ex post enforcement attempted

Avner Greif, "On the interrelations and economic implications of economic, social, political, and normative factors: Reflections from two late medieval societies." *Frontiers of New Institutional Economics*, eds. J. N. Drobak and J.V.C. Nye, Academic Press, 1997.

Two types of societies:

- (1) "Collectivist" - family, ethnic, or religious groups
  - Exchange occurs only between pairs of members of one group
  - Enforcement is through informal institutions of norms, communication, and sanctions
- (2) "Individualist" - social groups may exist, but
  - Transactions occur across groups between strangers
  - Enforcement is through specialized institutions and organizations

Maghribi (collectivist) and Genoese (individualist) traders in Mediterranean

Maghribis informed others in the group about any cheating, and ostracized cheaters

This was successful within the initial scope of trade, but could not expand because they could not find enough group members to migrate to new places

Genoese able to expand more flexibly because they

"developed formal organizations to support agency relationships and exchange"

- (1) formal registration of contracts and bookkeeping requirements
- (2) specification of default obligations if undocumented loss of another's property
- (3) making a cheater's family members responsible for his embezzlement.

Formal models of limits of collectivist or relation-based societies:

Shuhe Li, *Review of International Economics*, 11, 2003, 651-673,  
Avinash Dixit, *Journal of Political Economy*, 111, 2003, 1293-1317.

Avner Greif, "Impersonal Exchange without Impartial Law: The Community Responsibility System," Chicago Journal of International Law, 5, Summer 2004, 108-136.

Traders in late medieval Europe traveled from their communities to others  
They were not personally known outside their own communities,  
but others could know their community identity by clothes, speech etc.

If person P from community C cheated someone from another community C' ,  
then C' held C responsible to make restitution

Then C could conduct its own investigation to identify P and punish him appropriately

So communities are players in repeated game; each is formal enforcer within its boundary

Today partnerships and firms have some of the same role as the medieval communities

This is one way to overcome the limitation of relation-based governance  
and provide transition to anonymous transactions with rule-based governance

Other similar approaches include two-tier arbitration system described by Bernstein,  
theoretical model in Dixit, Chicago Journal of International Law, 5, 2004, 139-155

Possible applications for expanding the scope of microlending etc.

Avner Greif, Paul Milgrom, and Barry Weingast, "Coordination, Commitment and Enforcement: The Case of the Merchant Guild", *Journal of Political Economy*, 102 (1994): 745-776

This is somewhat different – about credible protection against a predatory state, not about enforcement of private property and contracts in the absence of a state  
Expansion of commerce in late medieval Europe depended not only on credible contract enforcement among merchants, but also on protection of their property against coercion or predation by rules of the trading centers

Organized groups of merchants (guilds and similar institutions)

could threaten a coordinated withdrawal of trade from a predatory ruler

Bilateral game between a ruler and a merchant would not work because individual merchant's future business would not be sufficiently valuable to the ruler

Multilateral but uncoordinated enforcement would not work because

each trader has incentive to violate embargo, and rulers would encourage this

With coordination, guilds solved the collective action problem of participation in the embargo by simultaneously putting in place sanctions against members who did not participate

Such a well-functioning institution also benefitted the rulers

by increasing the volume of trade in their city or market

So rulers would facilitate the organization and functioning of such guilds

Other functions of merchant guilds – administer trade, negotiate with foreign cities, ...  
Also distinguish from craft guilds, which could restrict entry and cartelize the activity

Paul Milgrom, Douglass North, and Barry Weingast, "The role of institutions in the revival of trade: The law merchant, private judges, and the Champagne fairs." *Economics and Politics*, 2(1), March 1990, 1-23.

Private judges under the "Law Merchant" in medieval Europe performed two functions:

- (1) a repository of information about traders' past behavior
- (2) adjudicator of current disputes

Repeated game equilibrium conditions can ensure

traders' honesty with each other and obedience to Law Merchant's judgements

Law Merchant's corruption-proofness mentioned but not investigated

This institution also contributed to the formulation of a

uniform set of standards for commercial transactions across large areas of Europe,

and therefore played a part in the evolution of modern commercial laws

But open question - Who / What keeps the judges honest, unbiased?

Answer - they are in bilateral repeated games with each of the parties that come to them

Judge's fee must be high enough to keep him honest and low enough to keep the trader honest (give enough "rent" to both sides)

Formal model developed in a Gambetta-type idea of enforcement by a

profit-maximizing mafia, in Avinash Dixit, *Econometrica*, 71, 449-481.

Lisa Bernstein

[1] “Opting out of the legal system: Extralegal contractual relations in the diamond industry”,  
Journal of Legal Studies 21 (1992): 115-157.

[2] “Private commercial law in the cotton industry: Creating cooperation through rules, norms,  
and institutions”, Michigan Law Review 99 (2001): 1724-1788.

Committees or tribunals of industry experts investigate and adjudicate complaints  
Their expertise enables them to interpret incomplete or ambiguous evidence  
better / faster / cheaper than can general-purpose courts of law  
(Note other more general forums of arbitration including international arbitration  
do not have this advantage – they can be costly and arbitrary.  
International ones are used more to avoid fear of bias of national courts.)

If their rulings are defied, they can put the miscreant out of the business  
Many in these communities are also linked by social ties among their families,  
so ostracism provides an additional punishment

When the system is working well, actual instances where cheating occurs are few,  
(default is more likely for reasons of financial hardship than for genuine intent to defraud)  
and ones where adjudicator’s ruling is defied and punishment invoked are very rare

Arbitration and formal courts can be mutually complementary, whereas  
relational governance can be hurt by partial improvement in formal institutions,  
because that makes it less costly to cheat within the relational group.  
Model in Avinash Dixit, Lawlessness and Economics, Chapter 2.

Elinor Ostrom, *Governing the Commons*, Cambridge U. Press. 1990.

Case studies of communities trying to regulate common pool resources (CPR)

More generally, example of privately provided **collective action**

[1] Determinants of success – "smaller stable communities (largest was 15,000) with repeated interaction and communication in a localized physical setting ... learn whom to trust, ... develop shared norms and patterns of reciprocity, ... [so they] can build institutional arrangements

[2] General method –

- (1) define a set of appropriators who are authorized to use a CPR
- (2) relate to the specific attributes of the CPR and the community of appropriators
- (3) **designed by local appropriators who have local knowledge**
- (4) **monitored by individuals accountable to local appropriators, with right incentives**
- (5) **sanctions against violators are graduated punishments**
- (6) presence of participants with substantial leadership or other assets

Mostly in conformity with general theory of repeated games

(Abreu-Pearce-Stachetti, Rotemberg-Saloner)

Except in use of graduated punishment instead of harshest feasible / trigger strategies

[3] **Adaptation to changing circumstances harder; helped by outside facilitator.**

## SOME PROMINENT FINDINGS FROM THEORETICAL AND EMPIRICAL STUDIES

1. Informal systems work well in small and stable groups with good communication  
But limited in size. Cannot keep up with expansion of scope of trade, investment.  
Leads to fragmented capital markets, conglomerates without economic synergies.  
Therefore essential to devise transition toward more formal institutions  
in the process of development, trade expansion
2. But problems of introducing formal institutions in a setting where informal ones prevail  
Imposing imperfect formal governance on top of existing informal institutions can  
disrupt existing relationships by making it less costly to cheat  
Must provide better paths of transition to formal institutions  
Better examples: two-tier community responsibility and arbitration systems
3. For-profit private information systems can work reasonably well  
in conjunction with social norms and sanctioning institutions  
Private adjudication can be effective if based on information and affinity (e.g. industry)  
But private for-profit enforcement can become expropriative (e.g. Mafia)
4. Important to keep down predation by the government and its agents  
Need large and organized private institution like medieval guilds that restrained monarchs

5. In relational governance, partner's honesty is sometimes best detected from unavoidable expressions (indexes), not actual actions (signals)  
This may explain businessmen's lengthy initial social interactions  
They are learning to interpret each other's microexpressions  
Foreigners from rule-based systems don't understand this and get impatient
  
6. More generally, firms from one LDC investing or trading in another understand the general nature of relational governance institutions better than do firms from western / northern countries with rule-based institutions  
Value of "intermediation" across systems – local partners, example of Hong Kong  
Extra value of cross-LDC trade and investment
  
7. Which institutions work well and which ones will prove dysfunctional depends sensitively on conditions of information, time-horizon etc.  
Better to use local access to such knowledge and build up, not impose top-down  
But when circumstances change and institutions must adapt and change, outside advisers can facilitate this (help select better equilibrium?)