

Institutions and the East Asian Miracle

Asymmetric Information, Rent-Seeking, and the Deliberation Council

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The deliberation council may be part of the reason rent-seeking is less of a problem in the high-performing Asian economies than in other developing economies. A council reduces information (transaction) costs by limiting the possibilities for opportunistic behavior. Opportunism reduces investment and thus retards growth.



Summary findings

North (1984) argues that it is not the cost of transport but the cost of transactions that prevents economies from realizing well-being — and that institutions matter because they affect the costs of transactions.

Campos and Lien analyze the role of the *deliberation council* — an institution common to most of the high-performing Asian economies — in reducing the crippling effect of rent-seeking.

A deliberation council is a consultative committee whose members include high-ranking government officials and representatives from the private sector — usually from industry (especially big business) and academia, sometimes from consumer groups and labor. Councils can be organized by industry or sector (as with the Industrial Structure Council in Japan) or by theme or function (as with Thailand's Joint Public Sector-Private Sector Consultative Committee).

Generally the deliberation council has a quasi-legislative authority, and policies cannot be introduced or changed without its recommendation and approval. Unlike a legislative committee, its private sector representatives are not elected but are chosen (by industry or labor, for example, and not necessarily through voting) and its government officials generally

become representatives by virtue of appointment to their present position.

Campos and Lien construct a two-stage incomplete information game model with two identical firms and various links to real-world processes. It is a highly simplified model that focuses on the awarding of government contracts.

They use the model to gain insight into the problem of rent-seeking in developing countries and to test their hypothesis. Rent-seeking occurs partly because people are uncertain about the intentions and plans of potential competitors — they engage in rent-seeking for fear that not doing so might give their competitors a huge advantage. To the extent that the council generates an exchange of information, this uncertainty is reduced, so one would expect less rent-seeking. Such exchanges reduce information (transaction) costs and thus improve efficiency.

The model confirms that firms are better off if they can communicate their true valuations to competitors than when they cannot. The deliberation council induces participants to reveal true information, and the model shows that the payoffs are better with communication than without.

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**INSTITUTIONS AND THE EAST ASIAN MIRACLE: ASYMMETRIC
INFORMATION, RENT-SEEKING, AND THE DELIBERATION COUNCIL***

Revised Draft

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Introduction

The high performing Asian economies have caught the attention of scholars, researchers, policy makers, and practitioners world wide. Their historically unprecedented performance has generated enormous interest in their economic policies. But while their success might be attributed to such policies, the role of institutions in these countries cannot be ignored. Without adequate supporting institutions, the very policies that have made these countries relatively wealthy could not have been properly implemented. Like many other developing countries, import substitution, export promotion, industrial transformation could have led to debilitating rent-seeking (Lal, 1985; Krueger, 1976; Bates, 1981; Bardhan, 1984). The Miracle materialized because institutions were established to facilitate the implementation of economically desirable policies.

Institutions perform the crucial function of mediating between rulers and their constituents and of governing relations among the constituents. As North (1984) has often argued, institutions matter. Why? They matter because they affect the costs of transactions among parties -- government and the polity on the one hand and different private sector parties on the other. "It is not transport costs but the costs of transacting that are the key obstacles that prevent economies and societies from realizing well-being. We can understand why when we examine analytically the costs of transacting in different situations."¹ In this brief paper, we wish to analyze one feature of an institution that has permeated policymaking in several of the successful East Asian economies -- the deliberation council.² This feature relates to the council's role in reducing the crippling effect of rent-seeking.

A deliberation council is a consultative committee whose membership consists of high

¹ North (1985), p.3.

² We define an institution as a set of rules and norms that govern a given set of individuals. For example, the U.S. Congress is an institution with a variety of rules and norms that bind elected legislators. Similarly, a deliberation council has a well-defined membership governed by a set of rules and norms.

ranking government officials and representatives from the private sector. The latter normally include representatives from industry, usually big business, and academia; in some instances, consumer groups and labor representatives also participate. A council can be organized along industry/sectoral lines, e.g. the Industry Rationalization Council in Japan, or along thematic/functional lines, e.g. the Joint Public Sector - Private Sector Consultative Committee in Thailand. It differs from typical consultative committees in other developing countries in its influence on policymaking. Unlike the typical consultative committee a deliberation council has quasi-legislative authority over matters within its jurisdiction and meets regularly (Campos and Root, 1994). It can be roughly equated with a committee or subcommittee in a western type legislature. Like the latter, it represents the interests of individuals and groups affected by the policies over which it has jurisdiction and it recommends appropriate policies. Furthermore, it enjoys a first mover advantage in the sense that policies cannot be introduced or changed without its recommendation and approval. Unlike a legislative committee however its private sector representatives are not elected but are selected by the various groups involved, e.g. industry and labor, according to rules that are not necessarily based on some type of voting scheme, and the government officials become representatives generally by virtue of their appointment to their current position.

Because it carries some authority over a subset of policies, a council draws active participation from private sector agents whose well-being may be affected by those policies. Hence, it provides a formal venue through which concerned groups and individuals can exchange information and views on a limited set of topics. This has important implications for rent-seeking. Rent-seeking occurs in part because individuals and groups are uncertain about the intentions and planned actions of potential competitors. This uncertainty leads them to engage in rent-seeking for fear that not doing so might give competitors a huge advantage. Because the council induces an

exchange of information, this uncertainty is reduced: cut throat rent-seeking competition is avoided.³ Consequently, with a council, one would expect the extent of rent-seeking to be lower. In the language of the institutional economist, a council reduces the information (transactions) costs and thus improves efficiency.

Because it is difficult to estimate the real cost of rent-seeking, it would be nearly impossible to obtain data and evidence to validate our hypothesis. Several interviews with participants in some of these councils certainly indicate that the introduction of councils has transformed "under the table dealings" into "over the table" transactions.⁴ But of course these are a small number of observations and for that matter are subjective. One alternative for increasing one's confidence in the validity of the hypothesis is to construct a reasonably representative analytical model and to determine whether or not the hypothesis can be deduced as an implication of the model. We attempt to pursue this line in this paper. In the following section, we develop the analytical model and derive the equilibrium. In the second section, we then discuss the implications of the model for rent-seeking. We conclude with some remarks on further research.

The Analytical Model

To underpin the analysis, we construct a two stage incomplete information game with two identical firms.⁵ At various steps of the building process, we will provide linkages with real world processes. The idea is to use the model to provide an insight into the problem of rent-seeking in developing countries.

³ This does not mean that there is no competition. In the Japanese case for instance there has been extensive competition in industries that appear to be cartels (see for instance Yamamura, 1985).

⁴ Interviews were conducted by Campos in 1992.

⁵ We could have a more general case with n firms. But this would not add much to our understanding of the basic problem we wish to investigate. It would shed light on problems of second order in magnitude.

The scenario is as follows. In the first stage, the government announces a project and each firm computes the value of the project to it -- how much is the project worth to the firm? The project could for example represent the building of a bridge or the provision of food and beverage service for the state owned international airport. We let v_i be the value to firm i of the project. Neither firm knows the true valuation of the other. This could be because each firm is controlled by rival families whose loyalties are divided along regional lines so communication is difficult and costly. Or it could simply be that each mistrusts the other.

However, each firm knows the probability and cumulative density function of v_i . That is, based on its experience in the industry, it has an idea of how v_i corresponds to different situations and the probability at which each situation occurs. Let the functions be $g(\cdot)$ and $G(\cdot)$ respectively. One can think of these functions as industry rather than firm specific.

Each firm must decide whether or not to participate in this project. Participation requires payment of an access fee of M . This might be interpreted as the cost of finding the right person in government who can connect the firm with the people in charge of the project. For example, one firm might approach the son of the President, another might go through the Senate President, and still another through the Finance Minister. If neither firm decides to participate then government officials award the project on a random basis without knowing the valuation of either firm.⁶

Participation is no guarantee that the firm will indeed get the project. In practice more often than not, a firm also has to expend some rent-seeking effort to bid for the project. This can be

⁶ The rationale for this might be that low paid officials do not want to incur the cost of evaluating individual firm capabilities without a corresponding side payment.

interpreted as the resources needed to obtain a favorable judgment from government officials in charge of the project. To capture this fact, we construct a second stage to the game. In this stage, each participating firm has information about the valuation of both firms (possibly through the information exchange of the two middlemen through whom the firms connect with the people in charge of the project) and must decide on how much rent-seeking effort to expend. The project is awarded to the firm that expends the most effort. We denote the rent-seeking effort by v .

The Equilibrium

To solve this game, we start with the end game, i.e. the second stage, and then, given the solution to the end game, go on to derive the solution to the first stage game. By a solution we mean the equilibrium strategy of each firm and the expected payoff given these strategies.

There are four possible events that could occur in the second stage: both firms participate; firm 1 participates and firm 2 does not; firm 2 participates and firm 1 does not; both firms opt out. The expected payoffs to each firm under each of the events differ depending on whether $v_1 > v_2$ or $v_1 < v_2$.⁷ Let us consider the first case, $v_1 > v_2$.

For the first event, it can be shown, a la Hillman and Samet (1987), that the Nash equilibrium is a pair of mixed strategies such that firm 1 expends any effort v with equal probability ($1/v_1$) and firm 2 any effort v with equal probability ($1/v_2$). The expected payoff to firm 1 and firm 2, given $v_i > v_j$ are $[v_i - v_j - M]$ and $(-M)$, respectively. The expected payoffs to each under the other events can be easily calculated. The expected payoffs for all four events are indicated in table

⁷ In the case of $v_1 = v_2$, both firms receive an expected payoff of $(v_i/2)$ in equilibrium. But since v_1 and v_2 are drawn from a continuous distribution, this case has zero probability. Henceforth we shall disregard it.

1a. Similar calculations can be made to derive the payoffs under case 2. These are indicated in table 1b.

Table 1a

		<u>Firm 2</u>	
		R	N
<u>Firm 1</u>	R	$v_1 - v_2 - M, -M$	$v_1 - M, 0$
	N	$0, v_2 - M$	$v_1/2, v_2/2$

Table 1b

		<u>Firm 2</u>	
		R	N
<u>Firm 1</u>	R	$-M, v_2 - v_1 - M$	$v_1 - M, 0$
	N	$0, v_2 - M$	$v_1/2, v_2/2$

To solve the first stage game, we have to know more about the information structure of the game. We consider two possible situations. In one no communication is possible between the two firms; in the other, communication of true valuations is possible.⁸ Let us start with the first situation. This involves a game of incomplete information. The equilibrium concept we will use is the Bayesian-Nash type.

We start with the following proposed strategy of firm i : participate, i.e. pay M , if $v_i > v_i^*$ and not participate otherwise. The constant v_i^* represents a trigger point determined ex-ante; by construction, $v_i^* < \bar{v}$. We assume that each firm knows that the other will follow this strategy. We will show that this strategy is a Bayesian-Nash equilibrium. To do so we first analyze firm 1's situation. To follow the argument it is important to keep in mind that each firm makes its calculations and formulates its strategy ex-ante, i.e. before the game actually begins.

Recall that in the first stage, firm 1 is able to determine its valuation v_1 once the government announces the project. It knows the strategy of firm 2: participate if $v_2 > v_2^*$; otherwise, do not. It also knows $g(\cdot)$ and $G(\cdot)$. Hence, it can compute its expected return given firm 2's strategy and its own valuation. It treats v_2^* as a parameter and v_1 as a variable whose value it will know once the game starts, i.e. the government announces a project. In this stage, firm 1 must decide whether to participate or not. Suppose it decides to participate. There are two possible cases it must consider: (a) $v_1 < v_2^*$ and (b) $v_1 \geq v_2^*$.

For case (a), the expected payoff (derived in part from tables 1a and 1b) is,

⁸ Under reasonable conditions, the case in which each firm strategically reveals the wrong information is equivalent to the case with no communication; Sobel (1992).

$$\pi_{1a} = -M \int_{v_2^*}^{\bar{v}} g(v_2) dv_2 + (v_1 - M) \int_0^{v_1^*} g(v_2) dv_2, \quad (1a)$$

and for case (b) it is,

$$\pi_{1b} = \int_{v_2^*}^{v_1} (v_1 - v_2 - M) g(v_2) dv_2 + \int_{v_1}^{\bar{v}} (-M) g(v_2) dv_2 + (v_1 - M) \int_0^{v_1^*} g(v_2) dv_2. \quad (1b)$$

After some algebraic manipulation, the two reduce to,

$$\pi_{1a} = v_1 G(v_2^*) - M; \quad \text{and} \quad (2a)$$

$$\pi_{1b} = v_1 G(v_1) - M - \int_{v_2^*}^{v_1} v_2 g(v_2) dv_2, \quad (2b)$$

Suppose instead firm 1 decides not to participate. Then its expected payoff is,

$$\pi_{10} = \int_0^{v_1^*} \left(\frac{v_1}{2} \right) g(v_2) dv_2 = \left(\frac{v_1}{2} \right) G(v_2^*). \quad (3)$$

Given $v_1 < v_2^*$ then firm 1 will participate if and only if $\pi_{1a} - \pi_{10} > 0$. If $v_1 \geq v_2^*$ then it will participate if and only if $\pi_{1b} - \pi_{10} > 0$. From equations (2a), (2b), and (3) above, we know that

$$\pi_{1a} - \pi_{10} = \left(\frac{v_1}{2} \right) G(v_2^*) - M \quad (4a)$$

and

$$\pi_{1b} - \pi_{10} = v_1 G(v_1) - M - \int_{v_2^*}^{v_1} v_2 g(v_2) dv_2 - \left(\frac{v_1}{2}\right) G(v_2^*). \quad (4b)$$

It can be shown that (4a) and (4b) are increasing in v_1 and are equal in value at v_2^* . That is,

$$\pi_1 - \pi_{10} = \pi_{1a} - \pi_{10}, \quad \text{if } v_1 < v_2^*$$

$$\pi_1 - \pi_{10} = \pi_{1b} - \pi_{10}, \quad \text{if } v_1 \geq v_2^*$$

with $\pi_1 - \pi_{10}$ continuous at v_2^* and increasing in v_1 .⁹ A similar solution can be derived for firm 2 following the same steps. This yields $\pi_2 - \pi_{20}$.

Note that in equilibrium, $\pi_1 - \pi_{10} = 0$ at v_1^* (given v_2^*): for any value $v_1 > v_1^*$, $\pi_1 - \pi_{10} > 0$; firm 1 would not want a trigger point that yields negative expected payoffs or one that eliminates some instances of positive payoffs. Similarly, $\pi_2 - \pi_{20} = 0$ at v_2^* (given v_1^*). Hence, we have two equations in two unknowns, v_1^* and v_2^* . The implicit function theorem guarantees the existence of a solution. Note that because the two firms are symmetric, $v_1^* = v_2^* = v^*$ in equilibrium. This implies, from (4a), that $(v^*/2) G(v^*) = M$.

It can be shown that the expected payoff (for the game) to either firm at the Bayesian-Nash equilibrium is,

⁹ At $v_1 = v_2^*$, $(\pi_{1b} - \pi_{10})$ becomes $(v_2^*/2) G(v_2^*) - M$, which is equal to $(\pi_{1a} - \pi_{10})$. Moreover, $d(\pi_{1a} - \pi_{10}) / dv_1 = G(v_2^*) / 2 > 0$; whereas $d(\pi_{1b} - \pi_{10}) / dv_1 = v_1 g(v_1) + G(v_1) - v_1 g(v_1) - G(v_2^*) / 2 = G(v_1) - G(v_2^*) / 2 \geq G(v_1) / 2 > 0$ when $v_1 > v_2^*$.

$$\begin{aligned} \pi = & \int_0^{v^*} \int_0^{v^*} \left(\frac{v_1}{2} \right) g(v_1) g(v_2) dv_2 dv_1 + \int_{v^*}^{\bar{v}} \int_0^{v^*} (v_1 - M) g(v_2) g(v_1) dv_2 dv_1 \\ & + \int_{v^*}^{\bar{v}} \int_{v^*}^{\bar{v}} (-M) g(v_2) g(v_1) dv_2 dv_1 + \int_{v^*}^{\bar{v}} \int_{v^*}^{\bar{v}} (v_1 - v_2 - M) g(v_2) g(v_1) dv_2 dv_1. \end{aligned}$$

After some manipulation, it can be shown that

$$\pi = M - \left(\int_0^{v^*} G(v_1) dv_1 \right) \frac{G(v^*)}{2} + \int_{v^*}^{\bar{v}} G(v_2) (1 - G(v_2)) dv_2. \quad (5)$$

To calculate the payoffs, we must make some assumptions regarding $G(\cdot)$. For tractability, we assume that $G(v) = (v/\bar{v})$ when $v \in [0, \bar{v}]$, i.e. v_1 and v_2 are uniformly distributed. This implies, that $v^* = (2\bar{v}M)^{1/2}$. To ensure an interior solution, we assume $M \leq (\bar{v}/2)$ so that $v^* \leq \bar{v}$. Upon substituting v^* into equation (5), we derive

$$\pi = \left(\frac{\bar{v}}{6} \right) - \frac{1}{12} \left(\frac{v^*}{\bar{v}} \right)^2 v^* > 0. \quad (6)$$

Note that there is no presumption here about what each firm actually does. This depends on its valuation v_i , which is revealed upon the government's announcement of the project, and on its trigger point v_i^* , which it calculates ex ante.

Now suppose that the two firms could communicate their true valuations. Assume $v_1 > v_2$ (similar results apply for the reverse case given symmetry). We can derive the equilibrium strategies for each of the three possible cases from tables 1a and 1b. These are:

Case I. The equilibrium strategy is (N,N). Neither firm participates if either (i) $v_1/2 < v_2 < v_1 < 2M$, or (ii) $M > v_1/2 > v_2$.

Case II. The equilibrium strategy is (R,N). Herein firm 1 participates and thus expends rent-seeking effort but firm 2 does not. This happens if either (i) $v_1/2 > v_2$ and $v_1/2 > M$, or (ii) $v_1 > v_2 > v_1/2 > M$ and $v_1 - v_2 > M$, or (iii) $v_1 > v_2 > v_1/2 > M > v_2/2$ and $v_1 - v_2 < M$.

Case III. When $v_1 > v_2 > v_1/2 > v_2/2 > M$ and $v_1 - v_2 < M$, the equilibrium is characterized by a pair of mixed strategies. In this case firm 1 engages in rent-seeking with probability $(v_1 - 2M)/(2v_2 - v_1)$; firm 2 engages in rent-seeking with probability $(v_2 - 2M)/v_2$.

We can now deduce that the expected payoff to both firms with communication is greater than the expected payoff without communication. To do so, we first characterize the three cases. This is done in Figure 1. Note first that since $M < (\bar{v}/2)$, the line with $v_1/2 = v_2$ will intersect the $v_1 = v_2 + M$ line from above. From Figure 1, we have

$$\text{AREA (I)} = 2M^2 ;$$

$$\text{AREA (II)} = 2 M (\bar{v} - 2M) + (1/2) (\bar{v} - 3M)^2 = (1/2) (\bar{v} - M)^2 ;$$

$$\text{AREA (III)} = M (\bar{v} - (5/2)M) .$$

Note also that the probabilities for Case I, II, and III are equal to the corresponding areas divided by \bar{v}^2 . Given symmetry, a similar argument can be made for the case in which $v_1 < v_2$.

Given the probabilities and the payoffs to each firm under each of the three cases, we can show that the expected payoff for either firm is greater than

$$\theta = \frac{4M^2}{\bar{v}^2} \left(\frac{M}{2} \right) + \frac{1}{2} \frac{(\bar{v} - M)^2}{\bar{v}^2} \left(\frac{2M + \bar{v}}{2} - M \right) ,$$

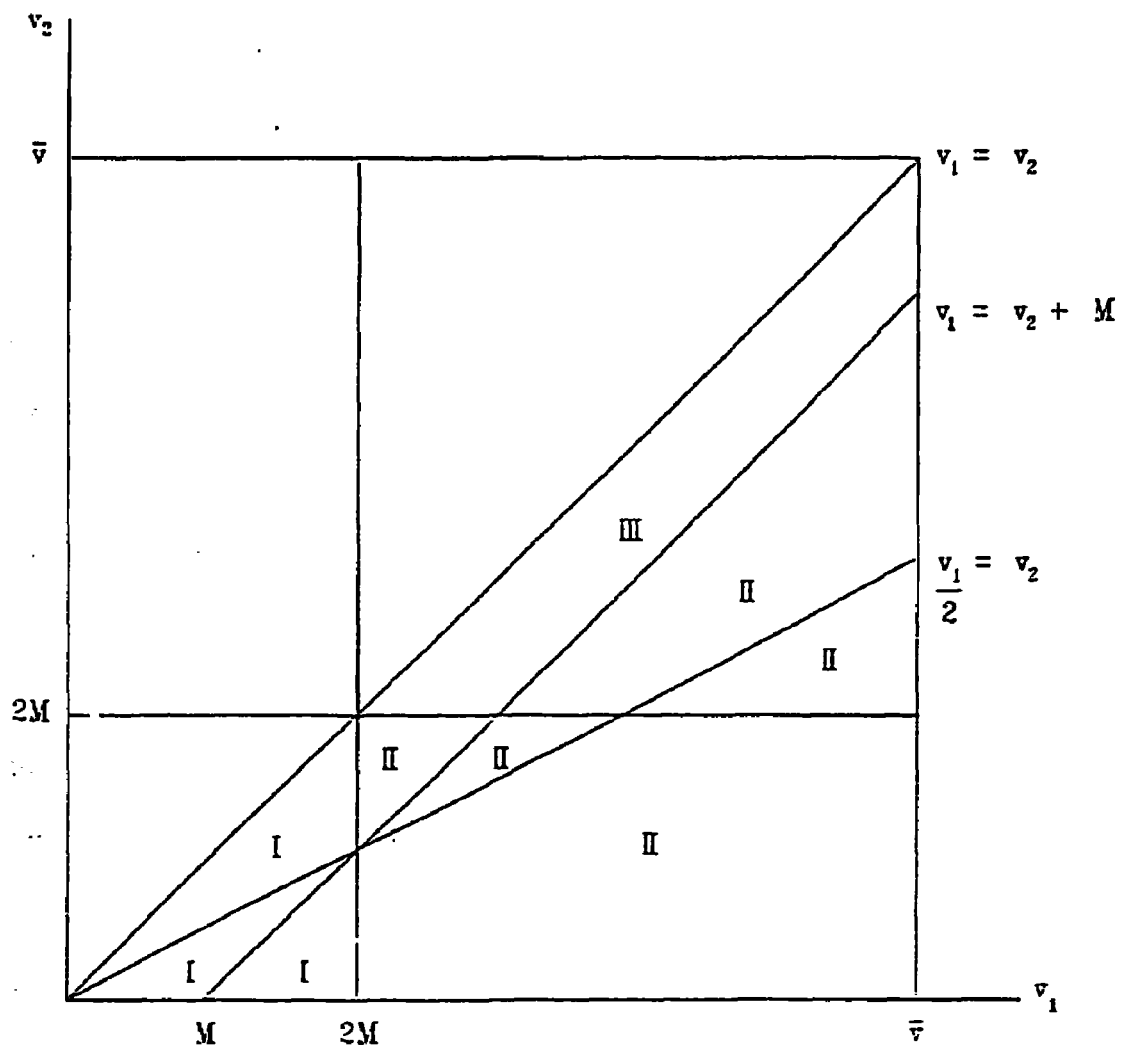


Figure 1

the expected payoff for Case I and II.¹⁰ After further algebraic manipulation, we can show that $\theta = (1/4) \bar{v} > (1/6) \bar{v} > \pi$ where π is the expected payoff with no communication. Thus both firms are better off with communication.

Implications of the Model

The model discussed above is highly simplified and focuses on the awarding of government projects. But it does drive home the point we made in the introduction. There is likely to be less resources lost to rent-seeking if competing parties can exchange (true) information. The model shows that firms are better off if they can communicate their true valuations to competitors relative to a situation in which they cannot. That is, their expected net payoffs are higher. Since the cost to each consists of the access fee and the rent-seeking effort and since the access fee is the same whether or not there is communication between the two firms, it follows that rent-seeking costs must be lower for each in the case where the two firms can communicate (at least in an expected value sense).

A key then to reducing rent-seeking is to make it possible for competing parties to obtain true information about their rivals. The deliberation council is one possible mechanism that can be used to this end. As mentioned earlier, this institution provides a formal channel for competing groups to exchange information. Several reinforcing factors induce participants to reveal their true information. First, because a council has real authority, it has value to private sector participants. The model suggests this. The equilibria above show that the expected payoffs with communication is greater than the payoffs in the case with no communication. Intuitively, each firm can know more about the possible actions of its competitors and can thus make better decisions. Hence, each will be inclined to support the creation of a council and to participate actively in it.

¹⁰ We assume that $M < (\bar{v}/3)$. Intuitively, what this means is that the access fee must not be too large.

Second, since members meet regularly, there is an element of repeat play. As much of the literature on repeated games suggest, this encourages cooperation. Third, government officials have the power to eject private sector participants if found to have revealed misleading or have failed to reveal useful information -- such deviations are likely to be discovered in subsequent meetings.¹¹ In turn, government officials have the incentive to reveal their true information for failure to do so would undermine the value of the council which could lead to the council's demise. The government would then have more difficulty obtaining information and getting the different parties to agree on policies.

Concluding Remarks

The paper has tried to address a puzzling feature of the economic development of the high performing Asian economies: why did rent-seeking seem to have been less problematic in these countries? We have suggested that one institution, the deliberation council, has helped mute rent-seeking in these countries by allowing concerned groups to exchange information and to use that information constructively.¹² This should come as no surprise since rent-seeking tends to occur less when rules, procedures, and actions are more transparent and when affected parties have recourse to deviant actions.

The more important message of this paper is that institutions that reduce transactions costs need to be established in order to speed up the process of growth. Development requires markets and markets involve contracts of some sort or another. And whenever there are contracts, there are

¹¹ For this reason, it is important that the bureaucracy be relatively powerful and reputable -- powerful to be able to enforce the rules and reputable to obtain the respect of private sector participants. The bureaucracy in this context is like a referee of a game. If the referee is weak and incompetent and if (s)he lacks impartiality, the game easily loses its value to the contestants.

¹² We do not claim that this is the only reason. Campos and Root (1994) give other reasons.

possibilities for opportunistic behavior. An important role of institutions in economic development is to inhibit opportunism. Opportunism reduces investment and thus retards growth.

In an Arrow-Debreu world, efficiency is achieved because all possible contingencies can be written into a contract. But, as Williamson (1985) has argued, bounded rationality makes this impossible. Hence, parties to a contract are often faced with the problem of opportunism. If an unforeseen event occurs one or more parties to the contract could easily renege. The solution must be some form of credible commitment that make it in the self-interest of parties not to renege. Good institutions perform a commitment role.

In the process of development, the most significant contracts are the implicit social contracts between the state and the polity, and among them, those between the state and business sector. The latter are the key to inducing long term investments. If potential investors cannot be certain about the sustainability of policies, they are unlikely to invest in long term projects. Changes in policies that are uncalled for, opportunistic behavior on the part of government, are likely to reduce the value of investments whose returns are based on existing policies. Rent-seeking tends to engender such changes in policies, changes that tend to favor some parties over others. Hence, it tends to discourage investment. By reducing the value of rent-seeking, a deliberation council indirectly performs a commitment function: less rent-seeking implies a more rational and stable policy environment.¹³

The council is but one example of an institution performing a commitment function in the service of economic development. There are undoubtedly many others to be found in the historical experience not only of the high performing Asian economies but also of the West beginning with

¹³ The council performs a more direct commitment function. Because it has some veto power over policies that affect its private sector participants, it gives the participants some confidence that these policies will not be altered arbitrarily. In Williamson's terminology (1994), it is a governance structure that limits the possibilities for ex-post opportunism on the part of the government. This feature of the council as well as others are discussed more extensively in Campos and Root (1994).

the industrial revolution in England. It would be extremely helpful to policy makers and development practitioners if specific institutions with similar features can be found in both sets of countries for this would suggest some basic principles upon which to build growth promoting institutions.¹⁴ For policy makers and practitioners, the main problem is not so much what policies to adopt but what institutions to create or promote in order to facilitate the implementation and sustainability of desirable economic policies.

¹⁴ There has been some initial work on the Western economies -- see for instance North and Weingast (1989), Root (1988), Weingast (1992) and Milgrom, North, and Weingast (1990) and on East Asia -- Campos and Root (1994).

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