Part I

The State and Development

1 Institutions as Investments*

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1 INTRODUCTION

In the 1980s, international capital markets nearly collapsed. In an effort to revive international lending, bankers and diplomats created new institutions and reformed old ones. And in an effort to become creditworthy, developing countries altered their economic policies and their structures of government.

Within the academy, the different reforms have been studied separately. Changes at the domestic level have been studied in isolation from international ones, and while economists, such as Sachs (1989), focus on the changes in economic policies, political scientists, such as Huntington (1991), focus on governmental reforms. The premise in this chapter is that the different kinds of reform must be studied together. In particular, I argue that the recent changes in institutions represent efforts to rebuild the international market for capital.

The theme is Marxian: efforts to augment the underlying forces of production – that is, to deepen the stock of capital – lead to changes in the overlying relations of production – that is, the institutional structure. But the approach is neoclassical. It derives from arguments that lie close to the foundations of the new institutional economics. It is to these I now turn.

2 THE TIME CONSISTENCY GAME

Capital requires exchanges over time. To form capital, people save. Withholding goods from consumption in one period, people invest, so that they can enhance their consumption in future periods. It is the prospect of reward in the future that motivates sacrifices in the present. The prospective rewards are uncertain, however. Among the risks are those of non-performance, or opportunistic actions by other human beings.

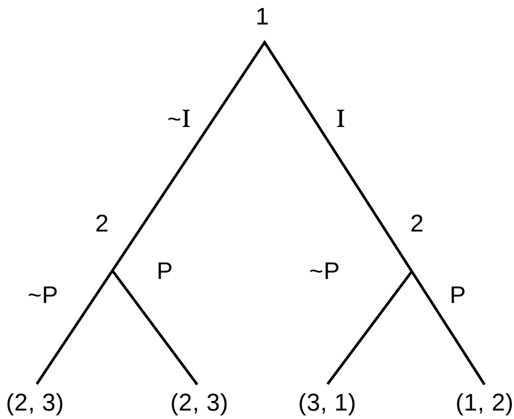

Figure 1.1 The time consistency problem

Notes:
1. Players: 1, 2.
2. Actions: I: invest; ~I: not invest
   P: perform; ~P: not perform.
3. Pay-offs: 1 is high; 3 is low.

In the face of such risks, individuals may fail to make investments that would render them – and, indeed, all people – better off. The desire to transcend this dilemma motivates the creation of non-market organizations, including political institutions.

The basic problem is captured in Figure 1.1. Player 1 moves first and chooses whether or not to invest (negation is signified by a tilde (~); investing is signified by a the letter I). Should Player 1 invest, Player 2 must then decide whether or not to perform (signified by P and ~ P, respectively). In the diagram, each player ranks the outcome from best (1) to worst (3), with Player 2's ranking listed second. As can be seen, should Player 1 invest, Player 2 can benefit from behaving opportunistically; as for example, by choosing ~P and confiscating the assets invested by Player 2. Knowing that, Player 1, will choose not to invest (~I), with the result that both players are worse off. Consistent period-by-period optimization thus generates outcomes that are neither privately nor socially optimal.

The implication of the analysis is clear: under such circumstances, pledges of restraint will not be believed; they would be discounted for being inconsistent with rational behaviour. And exchanges whose value depends upon the subsequent performance of others might not take place. To address this problem, the actors therefore have an incentive to alter the environment within which they transact. Player 1 possesses incentives to find means of restraining defection by Player 2. More subtly, Player 2, the potential opportunist, possesses incentives for restraint. Should Player 2 be able to restrain himself, Player 1 would then invest, and Player 2 would escape his or her least preferred outcome. Both could therefore be made better-off. Both could be made better-off if Player 2 was able to tie his own hands.

Being central to growth, capital is central to the process of development. Being inherently intertemporal, capital formation runs foul of the problem of time consistency. Building on the insights offered by the problem of time consistency, this chapter focuses on how the desire for investment, capital formation and growth motivate the creation of non-market institutions. In particular, it employs these insights to explore the ‘political’ restructuring of capital ‘markets’ following the crisis of the 1980s.

Before venturing into the role of formal institutions, however, I first examine informal means of safeguarding transactions over time. Anthropologists, including Cohen (1969) and Janda (1988) have noted the role played by culture and community in promoting transactions in markets. The section that follows illustrates and criticizes their arguments. Marshalling the logic highlighted by the time-consistency game, it argues that while informal mechanisms can support the mobilization of capital for commerce, they cannot provide safeguards for the mobilization of capital for the building of infrastructure or the formation of heavy industry. Industrial development requires formal institutions, such as firms or states. Indeed, it requires states with specific attributes; these are described in Section 5 of this chapter.

3 TRADE WITHOUT FORMAL INSTITUTIONS

In this section, I argue that informal organizations, such as communities, can support commerce and trade; that significant savings require a special kind of culture, which I call the culture of abstinence; but that neither community nor culture can support the creation of industrial capital.

The significance of bourgeois culture has been addressed by Weber (1968), as well as by economic historians, such as Hoffman (1984); by cultural historians, such as Schama (1987); and by novelists, such as Balzac (1861) and Dickens (1853). Probity, discipline and rectitude smother the Dionysian impulses that threaten the ability to form enduring commitments. As suggested by artists, in both literature and portraiture (Haskell and Teichgraeber, 1993), specific mannerisms – such as comporting oneself soberly and presenting oneself with gravitas – help to engender trust both in the boardroom and on the high street, where value can be lost unless people restrain their impulses, adhere to agreements and honour their pledges.

Further insight into the culture of capitalism is provided by anthropological studies, such as those by Norman Long (1978). Villages in Central Africa, Long demonstrates, contain a culture of generosity. Emphasizing the importance of hospitality, people use their savings to brew beer, provide food and finance feasts for friends and family members. To be a respected member of the community, one has to reciprocate the generous acts of others. In such a setting, however, it is difficult to save. People who spend their money entertaining others find it difficult to accumulate the resources with which to form capital, such as by investing in education.

With the expansion of industry and government, the returns to education have increased; so too have the costs of failing to save in order to finance the cost of education. The response, Long notes, has been the creation of an alternative to the beer culture. People seeking to advance in the new social order convert to a culture of abstinence. The converts dress smartly, wearing white shirts, ties, or modest dresses. They consume their meals while seated at tables, with cutlery and tablecloths, and they maintain tidy houses, with calendars on the walls and books and newspapers on the tables. The ethnographers emphasize that those who adopt the new lifestyle seek to distinguish themselves from those who belong to the beer culture. They comport themselves in ways that proclaim their sobriety. They thereby become ‘bankable’.

Figure 1.1 helps to clarify the logic underlying this argument. By engaging in visible displays of conscientious behaviour, Player 2 signals that his character is such that he would choose P over ~P, were Player 1 to invest. The effect is to increase Player 1’s expected gains from investing – and to change the outcome of the game. Were Player 2 to choose P, Player 1 would choose I, resulting in the formation of capital. Their choices would yield the socially desirable outcome.

Those who study the villages of Central Africa stress that villagers who abandon the beer culture acquire more than new, highly visible lifestyles. The ‘improvers’ or the ‘accumulators’, as others have called them, also construct new villages. They create new communities. Re-

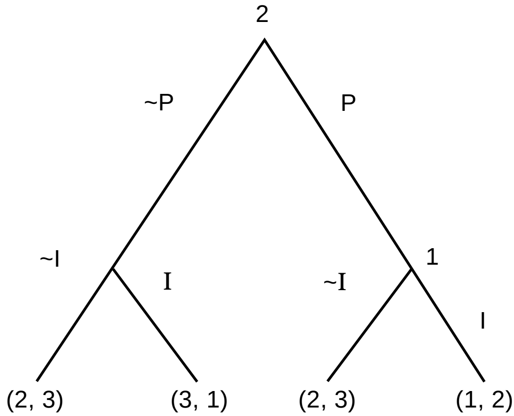

Figure 1.2 A solution

Notes:
1. Players: 1, 2.
2. Actions I: invest; ~I: not invest
   P: perform; ~P: not perform.
3. Pay-offs: 1 is high; 3 is low.
4. Player 1's pay-offs are still listed first.

turning once again to the games illustrated in Figures 1.1 and 1.2, we can gain insight into these phenomena as well. When Player 2 invests in a relationship with Player 1, Player 2 converts the interaction from a two-period into a multi-period game. Player 2's short-term gains from defection could thus be bought only at the price of a long-term stream of penalties inflicted by Player 1. For many reasonable rates of discount, the future losses might well outweigh the benefits of opportunistic behaviour. Player 1 can therefore be assured that Player 2 would not choose to behave opportunistically. In effect, by committing to life in a community, Player 2 becomes a hostage. By becoming vulnerable to retaliation, Player 2 puts himself in a position to commit credibly to pledges to perform. Community thus provides a mechanism for overcoming short-term incentives to behave opportunistically.[1]

Reflecting upon the logic of time consistency, we can therefore appreciate how social communities affect economic behaviour. Reputation on the one hand, and the possibility of punishment on the other, ease the making of commitments that are credible, and thereby facilitate exchange in intertemporal setting. Both, it should be stressed, require repeated interaction. A reputation for probity engenders trust if players know that others will refuse to transact in the future with someone who behaves opportunistically in the present; in this way, losing a reputation becomes costly. The power of punishment rests upon the prospect of future losses, as people retaliate for harmful acts. Visible displays of judicious behaviour and dense social ties: the power of both thus derives from repeated interaction, and the ability of iteration to ensure it is in the interests of maximizers to refrain from defecting from longer-term commitments for short-term gains.

While helping to account for the economic significance of informal mechanisms, such as culture and community, this reasoning also highlights their limitations. One way of registering the point is to note the contrasting characteristics of the transactions that underpin commerce as opposed to, say, those that underlie the construction of a major infrastructural project. Transactions in commerce may be reversible; goods placed on consignment can be recovered and sold through other channels. In the case of large projects, however, the infrastructure cannot be repossessed; even were the project portable, it might well be of little value in another use or location. The implication is that an investor in infrastructure is far more vulnerable to opportunistic exploitation. Secondly, in commerce, the transaction is divisible; a stock of goods can be broken up into small lots. By contrast, an infrastructure project, such as a dam, is lumpy; it comes as a piece that cannot usefully be subdivided. Moreover, a merchant can advance a portion of his stock; should the agent perform, he can then make further shipments. An investor in a large project, by contrast, engages in just a single transaction; the project is either built, or it is not. The implication of these considerations is that economic agents in commerce can better defend themselves against exploitation than can those in investment projects by mobilizing the incentives created by repeated play. They can make better use of the resources provided by culture and the community.

The differences between commerce and infrastructure also distinguish commerce from industry, or at least the branches of industry that require large investment in specialized equipment. Upright communities can underpin the prosperity of commerce: in both history and in the contemporary world we frequently find trading networks lodged within religious and ethnic communities (Meillassoux, 1971; Northrup, 1978). But while we encounter trade and markets everywhere, we encounter industrialization or capitalism far less frequently. The analysis of this section suggests why: the promotion of industrial investment requires other means of correcting the perverse incentives that arise from optimization in intertemporal settings. It also suggests that rather than informal defences, investment in industry requires defence by formal institutions.

4 THE CREATION OF FORMAL INSTITUTIONS

In seeking to invest in lumpy and specific assets, those seeking to transcend the dilemma of time consistency may therefore seek to lodge investment decisions in authority structures. One of the classic illustrations of this reasoning is provided by Klein, Crawford, and Alchien's (1978) study of General Motors, the automotive firm. General Motors once purchased auto bodies from another firm, Fisher Body. But the two corporations then encountered the problem captured by Figure 1.1. To supply auto bodies to General Motors, Fisher had first to invest in the creation of lumpy, expensive, highly-specific capital; valuable only in this use, the specialized machines and dies were without significant value in any other. The market provided insufficient safeguards: Fisher was reluctant to make the necessary investment for fear that General Motors would subsequently behave opportunistically, renegotiate the terms of its contract, and expropriate the quasi-rents that inhered in Fisher's physical capital. The solution was to move the transaction out of the market and into the firm. General Motors purchased Fisher Body. The cost of transacting at 'arm's length' and in a decentralized fashion proved to be too great. By acquiring command and control over Fisher, General Motors lowered the costs of transacting. It was then able to be assured of the investment it needed in the production of auto bodies.

One solution to the problem of time consistency is thus the creation of the firm. Another is the creation of the state. A state, or a 'stationary bandit' in the phrasing of Mancur Olson (1993), possesses authority over a region; it possesses uncontested 'ownership' of the streams of income generated by the private agents who dwell in its territory. As argued by Olson, the state thereby acquires a stake in the prosperity of its territory. The stream of income that flows from the region becomes part of its endowment, enabling the state to prosper. The alternative is to be, in Olson's words, a 'roving bandit.' The roving bandit possesses little incentive to conserve; the goods he refrains from despoiling will be harvested by others. In Olson's colourful language, the roving bandit will therefore behave like a wolf; the stationary bandit like a shepherd. Both will consume from the flock, but only the second possesses an incentive to defend and to nurture – that is, to invest.

The relevance of this argument for development is underscored by Leith and Lofchie's (1994) account of the economic collapse of Ghana. Following the coup that toppled the Nkrumah government, they argue, political control in Ghana remained highly contested. As a consequence, those in power had little incentive to conserve, rather than consume; indeed, they treated the economy like a common-pool resource, over which they possessed ill-defined ownership. Ghana's successive governments therefore extracted resources from export agriculture at too high a rate, without paying heed to the need to replenish the capital stock. Leith and Lofchie thereby explain the apparently irrational 'over-grazing' of Ghana's cocoa-based economy – the legendary killing of the goose that laid the golden egg – and trace it to a lack of 'political ownership'.

The creation of both the firm and the state constitute forms of vertical integration. The second-moving player merges with the first and, indeed, acquires ownership of the assets the first controls. Both forms of integration represent the substitution of authority relationships for decentralized transacting. The solution can be interpreted in two ways.

One emphasizes incentives. In so far as Player 2 – General Motors in one example; the bandit in the other – acquires ownership of the stream of revenues generated by the assets controlled by Player 1 – the potential investor – then Player 2 would not benefit from the harm inflicted by failing to perform. As a result of vertical integration, each player focuses on the sum of the pay-offs; the pay-offs are jointly owned. In the case of Figure 1.1, both would therefore converge on the efficient choice of strategies (I, P). By restructuring ownership, vertical integration thus internalizes costs that were formerly externalized, thereby correcting the incentives that perversely affect choices made in intertemporal settings.

A second interpretation focuses on power. Insofar as vertical integration implies embedding formerly autonomous agents within authority relations, then it can be thought of as altering the *structure* of the game. By acquiring the authority that inheres in ownership, the potential opportunist, Player 2, in effect becomes the first-moving player. As suggested in Figure 1.2, once the relationships are thus restructured, choices made out of individual self-interest will yield socially desirable outcomes. Restructuring the sequence of play to reflect the new structure of power removes the perverse incentives that confound intertemporal decision-making.

The argument in this section helps to explain why industrialization requires not just culture and community, but also institutions. While the informal sanctions of interpersonal behaviour and community may support the kind of repeated intertemporal transactions encountered in commerce and trade, they are insufficient for investments in fixed, lumpy and specialized capital. Such transactions cannot be defended through repeated play; they require formal institutions for their defence. Modern capitalism may arise in certain cultures; its 'spirit' may be transmitted by particular communities, but it also requires defence by formal institutions. Firms or states constitute the institutional foundations of the modern industrial economy.

It is difficult to test such arguments systematically. We must often rely upon narrative accounts. Some, such as Weber (1968), stress that industrial firms form bureaucratic organizations, with structures of authority and 'rational–legal' forms of discipline. Others, such as Chandler (1970), analyse the industrialization of the USA in terms of the rise of large corporations. Still others, such as Kolko (1970), trace both the rise of large firms and the regulatory state to the growth of North American capitalism.

For the relationship between the state and economic growth, we can marshal more systematic evidence. In a classic article, Barro (1991) attempted to account for cross-national variation in the rate of growth in real per capita incomes for ninety-eight countries over the period 1960–85. Measures of instability – or, more freely interpreted, of the presence of roving bandits – significantly and negatively related to the rate of economic growth when entered with other variables in the now-standard conditional growth equation. Moreover, the same variables – measures of the frequency of revolution, coups, and assassinations – were significantly and negatively related to the level of private investment in the economy, as was the level of government consumption, which Barro interprets as a measure of 'predatory' behaviour.

Recent studies have strengthened and clarified Barro's initial findings. Alesina and Perotti (1991), for example, seek to control for the bias introduced into Barro's analysis by the simultaneous relationship between economic growth and political instability. Rates of investment, they reason, may be a cause of, as well as being affected by, the degree of political order. Employing two-stage least squares, they relate cross-sectional variation in the rate of total investment to cross-sectional variation in the levels of political instability for a sample of seventy-one countries for 1960–85. Even taking into account the impact of investment on political instability, they find that increased instability significantly depresses the level of investment in their sample set of countries. Borner, Brunetti, and Weder (1995) report on the assessments of a sample of entrepreneurs on the degree of risk and policy instability in a sample of twenty-eight countries. When entered into a standard growth equation, the private investors' assessments of political risk help to account for nearly half the cross-country variation in the rates of economic growth, 1980–90.

5 REFORMING THE STATE

We can thus understand why economic agents, seeking the gains to be reaped from the creation of infrastructure and heavy industry, might restructure the environment for investment decisions, moving these from market settings and embedding them within hierarchical structures. While responding to one problem, this solution creates others. To understand the impetus for the reforms that accompanied the revival of capital markets in the 1980s, it is useful to focus on the problems that arise from the creation of the state.

The fundamental problem can be stated in various ways. One is in the form of 'Weingast's paradox': as B. Weingast writes: 'the fundamental dilemma . . . is this: A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens' (Weingast, 1992, p. 1). The very existence of a government powerful enough to protect the creation of wealth constitutes a threat to investment programmes. A second is in the form of the paradox of sovereignty. Governments are sovereign and therefore not accountable to any higher authority; rather than enhancing the power of governments, however, sovereignty weakens it. Given that governments can act as they choose, they cannot make binding commitments; people therefore cannot trust governments' promises. There are, therefore, agreements into which governments cannot enter, even though they might benefit from doing so.

As Elster (1979) argued, that just as Ulysses tied himself to the mast to resist the Sirens' call, so too do sovereigns seek to constrain themselves. Attempting to render infeasible alternatives that may be attractive in the short term, some seek to enhance their capacity to secure long-run gains. In seeking to enhance the outcomes, some governments reform: they do so by restructuring their institutions.

In their now classic study of the Glorious Revolution in seventeenth-century Britain, North and Weingast (1994) provide an example of such reforms. In particular, they demonstrate how a sovereign government, by constraining itself, in fact empowered itself by enhancing its capacity to secure capital. Monarchs, they argue, needed to finance wars; they therefore needed revenues, be it in the form of loans or taxes. But lenders feared that monarchs, being sovereign, would exploit with impunity their ability to default, and tax-payers feared that, if well-financed, the monarch would commit to ventures, such as wars, that would lead to yet further claims on their economic resources. The Glorious Revolution limited the power of monarchs and gave power over revenues to private interests, represented in Parliament. The Glorious Revolution, North and Weingast note, is often treated as strengthening Parliament and weakening the monarchy; but, North and Weingast counter, it in fact led to a far stronger executive as well, because by giving Parliament the power over public revenues, the monarch signalled his commitment to use private resources in ways that would be consistent with the objectives of those who contributed them. The result, they argue, was an increased willingness to lend. Britain's 'weak state' in fact gained greater access to public revenue than did the 'strong', executive-dominated states of continental Europe. Britain's civilian democracy financed and staffed the most powerful war machine of its era (see also Hoffman and Norberg, 1994).

An analogous argument is advanced by Firmin-Sellers (1995) in her study of Akyem Abuakwa, the traditional state of the Akyem, in the coastal forest of Ghana. Because of their ecological endowment, the Akyem could produce abundant cocoa at low cost; and because of their geographical location, they could readily export it to world markets. But cocoa production, Firmin-Sellers notes, requires high fixed costs: the forest has to be cleared, trees planted, and subsistence sustained for three to four years before the first crop can be harvested. Private agents therefore required that their rights to the stream of future income be assured before they would invest in the establishment of cocoa plantations. They also required public investment in roads, bridges and transport facilities.

In the provision of property rights, Firmin-Sellers argues, the Akyem were favoured by the existence of a government that possessed uncontested hegemony over the region. Craftily manipulating the British imperialists, Nana Offori Attah, the 'king' of the Akyem, ensconced himself in power. Under his leadership, the government of the Akyem gained a monopoly jurisdiction over the forest territory and the revenues originating from taxation of the exports from the forest. In Olson's terms, the government of the Akyem became a 'stationary bandit'. The problem was that, while the government acquired an interest in the prosperity of the cocoa industry, it remained a less than faithful agent of those who invested in that industry. It might not extract too high a level of tax revenues, but how, local investors wondered, would the government spend those revenues: on salaries and perks, or on infrastructure? On the multiplication of government jobs and hangers-on, or on services for the community? Lawsuits highlighted the degree of distrust between the people and their chiefs. So too did the low rate of payment of taxes to the government, and the slow rate of capital formation in the cocoa industry.

The Akyem faced a major possibility for riches if investment was first made in cocoa production. What was required, Firmin-Sellers argues, was for the government to convince investors that it would extract revenues in a rational manner and employ them productively. Nana Offori Attah addressed this problem by creating a new political structure: a form of local government called the Native Treasury.

In this structure, those who took the risks of investing – the private sector – received seats on a governing council; the monarch then served as their executive. The 'king' gained access to funds under a well-defined formula that generated revenue in proportion to the level of prosperity in the tax base. Under this new form of government, then, the monarch gave away power; rather than remaining a principal, he reduced himself to being an agent. The principal became the political representative of the private sector, including the owners of cocoa farms.

This reorganization of the government of Akyem Abuakwa, Firmin-Sellers argued, represented an attempt to give a guarantee to private investors that the executive would act in ways that safeguarded their interests. The owners of cocoa farms constituted the residual claimants of the industry; payments to factors – and to the state – represented claims on their profits. By putting the residual claimants in control of the government, the monarch signalled that he was willing to behave in ways that safeguarded profits, both by limiting the level of taxation and ensuring that revenues would be spent in ways that enhanced the future of the industry. Firmin-Sellers presents evidence that the reforms worked. The level of tax revenues paid to the government of the Akyem appears to have increased following the reform. And, certainly, the export economy boomed during the reign of Nana Offori Attah.

Investment in lumpy, site-specific and specialized capital thus appears to require the creation of structures of authority. As historians, such as Weber (1968), have stressed, the transition to industrial capitalism implies the movement towards bureaucracy, as embodied in the firm and the state. Understanding the logic of time-consistency provided insight into the micro foundations for such a macro level argument. While addressing some problems, however, the empowerment of agents introduces others; and governments, we have argued, have had to restructure in order to address them.

Historically, the creation of representative governments represents one way in which executives have 'disabled' themselves politically in order to enhance their power. Another is by transforming markets into organizations. As noted by Root (1989), because monarchs could with impunity default on their debts, when they entered capital markets, investors were reluctant to lend, thus increasing the government's costs of borrowing. In an effort to gain more favourable access to private capital, Root argues, monarchs therefore created consortia of lenders. In doing so, they lowered the risks to the borrowers: each now held a smaller fraction of the public debt; but they raised the costs to themselves of failing to pay their debts. The monarch could no longer benefit by defaulting on the single (marginal) loan; the benefits of the default would be offset by the costs of the reprisals taken by all (previous) lenders. With strong incentives in place to render them trustworthy, the monarch could now borrow more cheaply, and thus gain access to capital.

Faced with opportunistic incentives and the power to act upon them, monarchs confronted limitations on their ability to raise capital. Root shows how they therefore transformed the capital market into an organization, in which they faced a few large borrowers rather than a multitude of small ones. By organizing an external agency of restraint, they credibly signalled their intention to honour their obligations.

6 EXTENSION TO THE PRESENT

I have explored how states, with the power to behave opportunistically, created agencies of constraint and so tied their own hands. I have drawn on historic sources, by and large: the work of Firmin-Sellers, Root and North and Weingast. But the problem that confronted the struggling states of early modern Europe bedevils the developing nations of today: that is, how to organize so as to reduce the political risk to capital and thereby secure investment. In this section, I extend the argument to the modern era.

Following the Mexican default of August 1982, private lending virtually ceased to many parts of the developing world. International donors and financial institutions then began to restructure international markets for capital. In addition, they began to restructure the political institutions of debtor nations. It is notable that the reconstruction of capital markets has taken a 'non-market' form, or at least a form that has introduced a high degree of market imperfection. Under the sponsorship of the international financial institutions, lenders created country consortia, both among private bankers and public creditors. And the international lenders themselves provided co-ordinating mechanisms through which to signal to members of these consortia whether the borrower is performing in good faith, or at least in ways that would safeguard the ability to repay. These consortia and arrangements are run not only by bankers but also by ministers. To promote the flow of capital internationally, the market for sovereign debt has been transformed into a political organization.

Today organizations develop internationally to resemble those created domestically in the past, as states seek to build institutions capable of deterring them from behaving in a predatory fashion. Governments, seeking external funding, raise the costs to themselves of failing to perform, thereby signalling their willingness to perform in good faith and so enhance their access to capital. The restructuring of international capital markets in the present day parallels the restructuring of domestic capital markets in the era studied by Root (1989) and others – for example, Hoffman and Norberg (1994).

Governments in the developing world have responded ambivalently to this transformation, vigorously protesting about it on the one hand while submitting to it on the other. The analysis advanced in this paper provides an insight into their reaction. The surrendering of sovereignty is, in the short run, costly; defection, in the short run, pays. But the capacity to defect also imposes costs: diminished access to future streams of capital. To regain access to flows of capital, borrowers must allow themselves to be subject to agencies of constraint. By increasing the costs of exercising their sovereignty, they surrender discretion while enhancing their 'bankability'. The international flow of capital induces the creation of political organizations that limit the conduct of sovereign governments. And governments, seeking credit, surrender that discretion, even while decrying the costs of doing so, in order to secure the wealth that capital can create.

As suggested in a flood of recent studies, including Haggard and Kaufman (1992), and Bates and Krueger (1993), the crisis in international credit markets has promoted domestic political changes as well. Some have taken the form of changes in policy: the abandonment of import substituting industrialization, the move towards export-led growth, and so on. Others have taken the form of basic shifts in the structure of governance (see Huntington, 1991; Przeworski, 1991; Frieden, 1991). The two kinds of reform are often studied in isolation: the one by economists, and the other by political scientists. But, as suggested by this paper, they should be analysed together. In an effort to regain bankability and creditworthiness, governments changed their policies. Many altered their political structure as well.

We often fail to recognize the state-centred nature of the reforms of the 1980s. Both the international financial institutions and their critics portrayed the International Monetary Institution and the World Bank as pro-private sector and anti-government. Both institutions were seen as prescribing less government and more private markets. Underlying the arguments of defenders and critics of the international financial institutions is a belief that the private market can gain only at the expense of the state. The strengthening one of these, they presume, implies the retrenchment of the other. But, as argued in this essay, to secure access to capital, private agents must be able to embed themselves in institutions that will monitor, police and credibly restrain them from taking opportunistic actions. To gain the benefits that capital can generate, individuals need to forge effective political institutions, if only to signal visibly their determination to perform. The strengthening of the state is thus a corollary of the strengthening of incentives to invest. This is particularly so when people wish to indulge not only in trade and commerce – activities that can take place in informal markets – but also in fixed and specific investments – things that cannot.

The recreation of the international capital market in the 1980s, then, not only implied the building of international organizations: the highly imperfect, politically managed consortia of finances for developing nations; it also led to the reform of domestic political institutions. These were strengthened not 'at the expense' of the market, but rather 'in the service' of the market, and, in particular, of the market for capital.

It is notable that when domestic political institutions were revived in the 1990s, many took a democratic form. Rather than serving as a principal, the executive branch sought to reconfigure itself as an agent. Many governments adopted parliamentary structures, with wealth-holders gaining greater control over taxation and expenditure decisions. The executives, it should be noted, did not give power away to weaken themselves, but rather to gain access to the resources that would revive their ability to act. They shed sovereignty to gain power by gaining access to capital.

7 CONCLUSION

The flow of capital has inspired transformations in the institutions of human society. It has led to the creation of cultures and communities, which facilitate the forming of reputations for probity and increase the costs of losing them. It has led to the demand for the creation of political institutions. It has led to the restructuring of institutions in ways that reduce the ability of governments to use power in capricious or self-aggrandizing ways. Expenditure of time, effort and money in the creation of institutions represents a form of investment.

Notes

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1. This argument requires that the interaction persist over a lifetime, or that it be of uncertain duration. Were it of finite and knowable duration, then by the logic of backward induction the equilibrium based on the strategy of trust would unravel; it would not be subgame perfect. See any standard text, such as Rasmussen (1989).

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