

RESERVE BANK OF INDIA
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**GOVERNANCE INSTITUTIONS
AND
DEVELOPMENT**

Governance Institutions and Development ¹

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I greatly appreciate the honor of being invited to deliver the Brahmananda Memorial Lecture. I share the immense admiration and respect you all have for his scholarship, his teaching, and his untiring service for the economics profession and the country. It is indeed a privilege to give a talk in his memory. And it is a special pleasure to follow my long-standing friend Lord Desai, who gave the inaugural lecture in this series. But I must admit that, unlike Meghnad, my knowledge of P. R. Brahmananda and his work is indirect. During my college days in Mumbai my subjects were mathematics and physics, so I did not have the benefit of Professor Brahmananda's teaching. Some of my work on dual economies connected with his long line of work on wage goods, but my approach was quite different.

Let me begin with some memories of the time I left India to study abroad. I do so with a twofold purpose – to show how things have changed, and how they have not changed.

Although I studied mathematics and physics, I did have one occasion to visit the Reserve Bank. This was to get permission to buy £50 to take with me when I left for England. Now the rupee is *de facto* convertible for current account transactions. Indian multinationals are major players in making foreign direct investments. Unlike in Oscar Wilde's days, schoolchildren are no longer told to omit the chapter on the fall of the rupee.

¹ This is a draft of the P. R. Brahmananda Memorial Lecture to be delivered at the Reserve Bank of India, Mumbai, on June 28, 2007. The actual material delivered may differ slightly from this text. I thank Meghnad Desai and Vijay Kelkar for their perceptive comments and suggestions on a previous draft.

During my visits to many government offices to get various documents and permissions to travel, entry to almost any office required me to give an authorization signature from C. D. Deshmukh to the *chaprasi* guarding the door. Mr. Deshmukh had been the Governor of the Reserve Bank and Union Finance Minister, and in one of these capacities, his signature appeared on the ten-rupee note. I am sure this practice continues even now in many government offices. The denomination of the required note has surely risen many times, and the *chaprasis* are probably now called the Site Security Officers.

The problem of corruption has become very important in recent thinking on development policy. For example, the World Bank's governance web site, <http://www.worldbank.org/wbi/governance>, seems to focus almost exclusively on corruption. In the Indian context, observers like Luce (2007) identify it as a key issue affecting the country's growth prospects.

But corruption is only a part of the more general issue of economic governance, and of more general policy questions concerning the design and reform of institutions of governance. In this lecture I will sketch some of these issues. I will draw on the research of several others as well as some of my own, and will try to interpret these findings in the context of India. However, I am handicapped in two respects. I am primarily an economic theorist and only secondarily a development economist, and my research, although it draws on my reading of empirical and historical research about some other countries and times, has not focused on Indian questions. Therefore my thinking and suggestions must remain very tentative and must be interpreted with a lot of caution. I hope that some in the audience and the readership will guide me to related literature, and perhaps also collaborate in modifying and refining these ideas and their implications for India.

What Is Governance ?

Economic governance comprises many organizations and actions essential for good functioning of markets, most notably protection of property rights, enforcement of contracts, and provision of physical and informational infrastructure. In most modern economies, governments provide these services more or less efficiently, and modern economics used to take them for granted. But the difficulties encountered by market-oriented reforms in less-developed countries and former socialist countries have led economists to take a fresh look at the problems and institutions of governance. In this lecture I offer a brief and selective look at this research, and attempt to draw a couple of conclusions that may be relevant to India today.

The importance of secure property rights can hardly be overstated. Without them, people will not create or improve the assets, physical and intellectual, that are essential for economic progress. De Soto (2000) builds the argument and marshals the evidence in a thorough and compelling book. Security of rights improves the incentives to save and invest. Land and capital can be rented out to others if they can use it more efficiently, so inefficient internal uses are avoided. And the assets can be used as collateral to borrow and expand one's business. Field (2006) has taken the case even further. Security of property rights not only increases the supply of capital and efficiency in its allocation; it also increases labor supply. When titles to land and capital are official and secure, people need not spend time and effort to guard their rights, so they can put the labor and time to productive uses. Field's empirical research on the titling program in Peru finds large and significant effects: "For the average squatter household, property titles are associated with a 14% increase in household work hours, a 28% decrease in the probability of working inside the home, and a 7.5% reduction in the probability of child labor among single-parent

households. Panel estimates ... support the cross-section results: between 1997 and 2000 household labor supply increased an additional 13 hours per week for squatters in neighborhoods reached by the program.”

In the Indian context, security of land titles may be the most important issue of property rights. The controversy regarding land sales in the context of the Special Economic Zones (SEZ) is a case in point. The merits of the SEZ policy can and should be debated, but if the debaters raise fears of revocation of rights and benefits that have been granted through a proper policy process, this uncertainty will deter investors and merely ensure that the potential benefits will not materialize. At a more micro level, insecurity of land rights and fragmentation of land arising from disputes in extended families constitute serious constraints on agricultural growth.

The relevance of security of contracts may not seem so obvious, but it is equally important. In most economic transactions that can create economic gains for all parties, some or all of them can gain an extra private benefit while hurting the others, by violating the terms of their explicit or implicit agreement. The fear of such exploitation by the other party may deter each from entering into the agreement in the first place. This was brilliantly illustrated by Diego Gambetta in his ethnographic sociological study of the Sicilian Mafia (1993, p. 15). In the course of his interviews, a cattle breeder told him: “When the butcher comes to buy an animal, he knows that I want to cheat him [by supplying a low-quality animal]. But I know that he wants to cheat me [by renegeing on payment]. Thus we need ... Peppe [the Mafioso] to make us agree. And we both pay Peppe a commission.” By providing a mechanism of contract enforcement, Peppe makes it possible for the two to enter into a mutually beneficial transaction. And he does this

with a profit motive, exactly as would any businessperson providing any service for which others are willing to pay.

This example also demonstrates something else that is an important theme for me: governance does not have to be provided by the government as a part of its public services; private parties may do so with other motives. In most countries, even advanced ones, we find a mixture of the formal legal system and a rich and complex array of informal social institutions of governance. These mixtures reflect the country's level of economic development, and in turn help determine its economic prospects.

The issue is not the old-style one of “market versus government.” Rather, it is one of how different kinds of institutions (governmental and non-governmental, formal and informal, industry-based or community based, singly or in combination) provide the support that is required for successful economic activity (exchange, production, asset accumulation, innovation, and so on), and the activity may or may not take place in conventional markets. I cannot emphasize too strongly the need to get beyond the old sterile debates and on to issues that really matter.

What forces threaten property rights and contracts? And how can we design and reform institutions to counter these threat? Let us look at some theoretical concepts and examples.

Property Rights

If the arm of the government's law is distant or weak, some people will seize every opportunity to steal valuable property from others. Of course there are many non-governmental institutions that

attempt to reduce this risk. Parents and schoolteachers strive to instill in children at an impressionable age the norms of respect for others' property. Individuals guard their own property and contribute to community policing. Communities can even evolve their own set of rules of ownership; we have evidence on this point from some unusual contexts, such as the American wild west (Libecap, 1989) and New England whalers (Ellickson, 1989). Such arrangements succeed to different extents, because each faces its own limitation of what can be observed and enforced. In fact even the rules have to be adapted to these limitations; attempting to put in place an unworkably stringent set of rules would only bring the whole framework into disrepute.

Thus private theft can flourish when public laws are weak, and private institutions can cope with it only to a limited extent. However, the biggest threat to property rights in many countries comes not from private individuals who exploit weakness of government institutions, but from the government itself and its agents. These threats need not take the form of outright theft. In fact confiscation or nationalization without compensation has been relatively rare for the last four decades.² The problems are more likely to be indirect: unexpected and arbitrary increases in tax rates and imposition of constraints on uses of property and repatriation of profits, and last-minute hold-ups from officials who demand extra kickbacks or bribes.

I want to emphasize that the big problem is the unexpectedness and arbitrariness of these actions of the government and its agents. A predictable tax or a predictable level of corruption will also deter economic activity, but the deterrent effect of uncertainty is likely to be

² But such seizures may be on the rise again, from recent populist governments in some countries and the expansion of the use of eminent domain in the United States and elsewhere.

much bigger.³ Thus Pritchett (2003, p. 148) finds: “Under a regime that has reasonable institutional stability and is not completely dysfunctional, a rapidly increasing level of GDP per capita is possible up to semi-industrialization. ... [A]t their best, these types of regimes, while they tolerate high levels of corruption, also demand some performance such that corruption does not become absolutely disorganized.” Note the qualification “up to semi-industrialization.” Progress beyond this point requires much more: “The policies required to initiate a transition from low-income equilibrium to a state of rapid growth may be quite different from those required to re-ignite growth in a middle-income country” (Rodrik 2003, p. 17). Therefore it may be especially important for India to curtail corruption if it is to ensure progress beyond its current stage of development.

How can people ensure that their government and its agents respect property rights? Waiting for the government to eliminate corruption may be futile. But the most that any one person whose rights are violated can do is not deal with that official or agency again, at worst by withdrawing from that form of economic activity. He cannot on his own persuade his friends to do participate in a boycott on his behalf; they have too much to gain by going along with the system, and the official can always promise them better treatment. Therefore individuals can do little; collective action is needed. Greif, North and Weingast (1994) show how merchant guilds in medieval Europe performed this function to keep monarchs from expropriating foreigners trading in their realms. Perhaps confederations of industries in modern economies can perform similar functions. Any one firm or industry may be tempted to get along and comply with demands of corrupt officials and agencies to secure a

³ Even more generally than in the context of corruption, the stability of policies can be extremely important for promoting investment. Uncertainty creates an “option value” of waiting, and thereby acts as a powerful deterrent on investment; see Dixit and Pindyck (1994).

favorable treatment for itself; at a minimum, any one firm or industry may feel itself helpless to resist. But all firms and industries should recognize that such practices hurt them all in the long run. Therefore they should be willing to organize and collectively commit all their members to resist these pressures. They can enforce that commitment using the threat that other members would refuse to trade with anyone who complied and gave bribes. If this can be done in conjunction with generating adverse media publicity about corrupt officials, which again organized industry groups can do better than can individuals, the effect is likely to be reinforced.

The research concerning property rights and corruption has yielded some useful conceptual distinctions and implications. The first is the distinction between *de jure* and *de facto* effectiveness of governance. The distinction is most vividly seen by contrasting China and Russia. China, at least until recently, had very little formal legal protection of property rights, especially those of foreign investors. However, in practice it has been able to deliver sufficient security to continue to attract large foreign investments. Russia has a much better legal framework on paper, but reality seems much worse. What explains the difference?

Qian (2003) and Rodrik (2004) emphasize the role of the Township and Village Enterprises (TVEs) in China. This system turned local officials into owners and residual claimants, giving them the incentives to make efficient decisions; if they were corrupt they would be stealing from themselves. But insider privatization in Russia had exactly the same aim (Shleifer and Treisman, 2000, pp. 31-2), and did not work so well.

McMillan (2003, p. 100) offers a different explanation: “High officials in Deng Xiaoping’s government understood enough about economics

to recognize that growth requires markets and markets require assured property rights. The Communist Party had retained its highly disciplined organization and so was able to prevent self-seeking behavior by low-level officials.” The top level in Yeltsin’s Russia may have had the same understanding, but presumably lacked the disciplined organization. If this explanation has some validity, the intentions and authority of the top levels of government are an important determinant of whether corruption and violation of property rights can be effectively controlled.

The top level of government, even if itself well-intentioned, needs sufficiently drastic punishments at its disposal to keep the lower and middle-level agents in check. This may be more difficult in a democracy than in an authoritarian regime. But even a harsh authoritarian or dictatorial regime can have troubles with its agents. Stalin had, and used, punishments as drastic as one could imagine, and yet could not get his officials to perform efficiently. What went wrong? Gregory and Harrison (2005) argue that Stalin’s harsh incentives did not work well because his methods for detecting shirking were arbitrary, imprecise, and themselves open to corruption. People found that they ran almost the same risk of being denounced and punished when they worked hard as when they shirked or cheated. Therefore they did not have the incentive to work hard after all. An accurate detection procedure is important for the success of any incentive scheme, including an anti-corruption one.

The second finding I want to highlight is the distinction between organized versus disorganized, or unified versus non-cooperative, corruption. Shleifer and Vishny (1998, Chapter 5) emphasize this aspect. If a project needs nineteen permits issued by nineteen separate licensing and regulatory agencies, each of them can try to extract as

much as they can from the applicant, not taking into account the fact that the implied tax levied by each of them discourages the activity and thereby reduces the take of all the others. If all nineteen permits are in the hands of one agency, it will recognize this interdependence and therefore will impose a lower tax, that is, engage in less corruption.⁴ This argues for the creation of “one-stop” licensing and regulation authorities for each kind of economic activity. Many U.S. states, and some countries like Virgin Islands, have adopted such streamlined procedures for business licensing. India enacted a similar agency, the Foreign Investment Implementation Authority (FIIA) in 1999. But I have not been able to find any independent studies of how well it works in practice. There are good arguments for ensuring its effectiveness, and establishing similar agencies for domestic investors as well. A key issue in India is how well one-stop authorities can coordinate all the licensing requirements of the multiple levels of governments in India: central, state, and local. Unless this can be done, multiple governments will continue to require multiple stops, to the detriment of investment and growth.

A related issue is the effect of competition. Shleifer and Vishny point out that in the United States no one has to bribe anyone to obtain a passport. There are multiple offices and multiple windows where one can apply for a passport; if one official asks for a bribe, the applicant can simply go to another. Competition between these officials lowers the “price,” in fact all the way to zero. Can the same be done with “one-stop” agencies? What if there are multiple agencies of this kind, each of them authorized to provide all the clearances an investor needs, so they are forced to compete with one another?

⁴ The economics jargon for the higher total burden of corruption imposed by multiple authorities acting together is “double marginalization,” and its cause is the “negative externality” that these authorities exert on each other. If they act collectively, they will internalize this externality.

Finally, consider a country that is introducing a modern and formal system of titling as De Soto and others would recommend. They are not doing this with a complete clean slate. Most societies without formal legal titling have some traditional system of rights, determined by tribal chiefs or village elders or heads of extended families, and enforced by these traditional authorities using various systems of social norms and sanctions. These rights may not work perfectly, but they exist, and will interact with the formal rights that are being introduced. If this interaction is dysfunctional, the formal rights may not work as western advisers would wish. Ensminger (1997) found just such a problem with land rights in Kenya. The traditional system guaranteed shares (usufruct rights) to various members of the extended family of the purported owner. This made it infeasible to use the land as collateral in a loan application from a formal sector bank, thereby defeating one of the most important advantages of titling offered by De Soto.

Kranton and Swami (1999) found that the introduction of civil courts in colonial India interacted adversely with agricultural credit markets in just this way. Competition among lenders increased. But traditionally lenders used to reduce risk for farmers by subsidizing their investments in times of crises; they could no longer do so because the courts enforced only simple debt contracts, not complex contingent risk-sharing ones. The overall outcome was a worsening of social welfare. These examples bring out the importance of ensuring that new formal systems relate synergistically, not adversely, with the informal and traditional systems.

Contract Enforcement

The courts in 1990s Italy may not have been perfect, but they were surely fairly competent in matters of simple contracts like that for the sale of an animal by Gambetta's cattle breeder to the butcher. Then why

was the pair relying on Peppe for enforcement? The answer is that they were trading in a clandestine slaughtering market, to avoid the tax levied on officially registered traders in the formal one. In such cases the private enforcement can be socially harmful even if it “works.” If the government disrupted the mafia, the traders may shift to the formal market, which may supply other useful things like an assurance of quality to the ultimate consumers. But if failures of the state’s formal legal system are the reason for the emergence of private enforcement, then that may be a good “second-best.”

More generally, whether a formal or an informal system of contract enforcement, or some mixture, will work best depends on the relative costs and benefits of the two in particular contexts.⁵ The potential advantages of a formal system are evident. Such a system has universal coverage in the country; one party to the contract cannot back out of it claiming to be outside its jurisdiction. The rules of the system are set out in its laws and precedents, and therefore are known to all participants (or should be so known). And compliance with the system is ultimately secured by the government’s coercive powers.⁶

By contrast, informal systems must rely more on voluntary participation of the members of a more limited group or community. Usually the only way to secure such participation is to exclude those who misbehave from benefits of continued membership. In some associations of traders in an industry, this can work well. Bernstein (1992, 2001) has studied diamond and cotton traders’ associations in the

⁵ The following paragraphs give a very brief and selective discussion of this. For more detailed analyses, see Dixit (2004) and Greif (2006).

⁶ These coercive powers ultimately depend on other people’s willingness to exercise them - judges to hand down punishment, and the police or the prison authorities to carry them out. Laws and regimes that tried to be more coercive than their citizens were willing to tolerate have fallen into disrepute and collapsed. See Mailath, Morris and Postlewaite (2001) for a discussion and game-theoretic analysis of this.

United States. She finds that their arbitration procedures have drastic punishments at their disposal. They can basically drive a persistent miscreant out of business; moreover, since the members also mix socially, they can ostracize not only miscreants but also their families. However, such drastic punishments are not invoked readily or quickly. Contrary to the theory of repeated games where the best tacit cooperation is sustained by inflicting the most severe feasible punishment upon any deviation, milder penalties are tried first and are escalated only if misbehavior persists.

An informal system in a limited community can have advantages over formal legal systems. Many of these pertain to information. In an industry-based arbitration system, the judges are expert insiders who can interpret and evaluate the evidence more accurately than can the “general practitioner” judges of state courts.⁷ Such communities also have good gossip networks; therefore they can spread the word quickly when someone reneges on a contractual obligation, thereby destroying his reputation in the whole community of traders. However, these advantages are eroded if the group becomes too large or its scope expands beyond a narrow range of expertise.

Given this balance of considerations, it is not surprising that formal and informal systems coexist and interact, even in advanced economies. Many contracts in the United States specify that disputes will be settled by arbitration. And even without such explicit stipulation, disputes are often resolved by negotiation between the parties. Going to the court is often the last resort; some estimates are that only 10% of disputes end up in courts.

⁷ The latter can have the benefit of expert testimony, but experts can have their own biases which the judges must somehow figure out and take into account.

The need for alternative institutions for resolving contractual disputes is even more pressing in India, where one estimate puts the backlog of court cases at over 300 years. Of course good lawyers can cut through this, but the other side can also hire a good lawyer, and the fear of high costs of litigation can be a powerful deterrent on business.

Of course improvements in the state's formal system of contract enforcement are also badly needed. Informal systems, with their reliance on group or community-based networks of information flow and sanctions on miscreants, are inherently limited in their scope. As India's economy expands and integrates both nationwide and internationally, more and more transactions must occur among strangers who do not belong to the same network, and formal institutions become increasingly important for providing good external governance.

Reforms of formal institutions of contract enforcement, as in the case of property rights institutions, should try to build synergistically upon the traditional informal ones. Theoretical considerations and practical experience alike suggest that industry-based arbitration and formal courts interact well together. A division of labor can emerge where insiders use their expertise to interpret the facts and take into account various customs and practices in contracts to arrive at a decision, for example who owes what damages and to whom, and then the courts can stand ready to enforce this verdict, backed by the state's powers of coercion. If the industry-based arbitration forum had to enforce its own decision, it would have to rely on the repeated game mechanism, and this typically involves some loss of efficiency.⁸ The combination of

⁸ In the jargon of game theory, the outcome is a second-best, subject to dynamic incentive compatibility constraints.

expert decision-making and court enforcement can achieve the best of both worlds.

In matters of governance of contracts between nationals and foreigners, the latter often fear that domestic courts will be biased against them. Various international forums of arbitration are available, each based on a different legal tradition, and such contracts often stipulate that any disputes will be adjudicated in a designated forum. Unlike industry-based dispute resolution institutions, these international forums usually do not have expertise in the specific matter at hand. They can be slow, costly, and even somewhat arbitrary; almost their only merit is their perceived lack of bias. If Indian courts or Indian industry-based institutions can develop a credible reputation for not favoring their own nationals, they will have an immense advantage when it comes to entering into contracts with foreigners, in particular in attracting foreign investment. Indeed, this may be a key to success as India integrates with the world economy and attempts to obtain gains from globalization.

Collective Action

I have ventured to make several suggestions on how the institutions of economic governance can be improved. These suggestions were mostly based on well known case studies in other countries and at other times. Therefore some of my suggestions may prove to be impractical in the Indian context. But let me continue and make some further suggestions on how the reforms can be made to work.

Most importantly, I think that waiting for the political process to institute the needed reforms “top down” would be a mistake. During my youth in India four or five decades ago, I saw that people relied too much on the government to do everything, but “*maa baap sarkar*”

often disappointed these expectations. The experience of the last two decades has hopefully shown Indians what individuals given freedom of enterprise can achieve by way of industrial progress; the same can be done, given a little additional dose of collective action, for institutional reform.

Even in Western countries, such reforms were often launched by visionary social entrepreneurs, and only later adopted by wider business communities or officialdom. Even something as basic as periodic publication of companies' audited accounts was initiated privately by J. P. Morgan when he started Federal Steel with Elbert Gary in 1898, because they believed that "corporations issuing publicly traded securities had to account for their financial performance" (Strouse 2000, p. 398). Later this principle was taken over and implemented in legislation by the progressive movement under Theodore Roosevelt. And recently the CEO of Aflac, an insurance company, has voluntarily allowed the shareholders a vote on his compensation; this may also spread. Perhaps one or more business pioneers in India will likewise realize that good governance is good business because the credible guarantee of contract fulfillment attracts more serious contractual partners. Then they can, in groups or in some cases even singly, take actions to improve governance. Institutional investors can similarly play a major role in improving corporate governance; in the US it is said that the California public employees' pension fund CALPERS has been more important than the Sarbanes-Oxley act in this way. Corporate governance in India may be even worse than in the United States, and the improvements in this matter will emerge as an extremely important issue as the economy grows and shareholding becomes more widespread.

In dealing with corruption, shining light on corrupt activities and exposing them to fresh air may be the most important starting point. In this respect India has the great benefit of a free press; no government and no media mogul should be allowed to depreciate this asset. The Right to Information Act can have major beneficial effects by removing information asymmetries and improving accountability. Public interest litigation and “people’s courts” can also serve a useful role, although sometimes such institutions can act for very small and single-issue interest groups and thereby become an obstacle to much-needed economic progress. Here India’s democratic tradition may hurt.

On the whole I believe that bottom-up and organically generated reforms will work better than imposed top-down ones. This finds support in many case studies conducted by Ostrom (1990) and her students. They find that local information, locally designed incentives, and local enforcement by norms and sanctions, all help explain the success of many successful instances of collective action. In India, there is scope for improving the provision of many public goods by greater decentralization and harnessing local initiatives. But one should not expect perfection; some recent research on public projects in Africa finds that local elites can also become corrupt and siphon away a large proportion of the gains intended for the general population.

Finally, I think that the process of designing institutional reforms offers a good opportunity for fruitful collaboration between academic economists and businesspeople. Many academic economists used to dislike or disdain businesspeople and prefer a statist solution to economic problems. This is much less true in western countries these days, but the tendency may be more persistent in India. I hope even they will regard the task of improving the institutions of economic governance in a favorable light, seeing it as a way of constraining the

opportunistic behavior of businesspeople.⁹ Many of them will also be attracted by the idea of a bottom-up rather than a top-down reform. There is a wealth of academic studies, theoretical and empirical, of the evolution, performance, and limitations of such institutions. Businesspeople have a clear perception of the specific governance needs of their industries. The two can combine their brains and energies to adapt the lessons of these studies to the Indian situations, and contribute to creating a better environment for continued rapid economic progress of the country.

⁹ I have argued that even businesspeople, when they regard their whole conduct of future business, recognize the benefit of establishing a system that curbs opportunism and promotes respect for property rights and contracts. More generally, this is true of all “moral hazard” problems: people agree on the *ex ante* desirability of reducing such “hazardous” behavior, even though they are tempted *ex post* to engage in it.

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