

Perspectives on Growth and Poverty

Edited by Rolph van der Hoeven
and Anthony Shorrocks

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Collective values, behavioural norms and rules: Building institutions for economic growth and poverty reduction

Ke-young Chu

1 Introduction

Countries reduce poverty by achieving economic growth. This is how the Western world and, more recently, Japan and newly industrialized countries have reduced poverty. Countries achieve growth by building efficient economic and political institutions, defined by North (1990, 1994) as humanly designed rules, which promote the productive activities of economic agents by enhancing allocative efficiency at low enforcement costs. Essential elements of institution-building for economic growth and poverty reduction are the development of transaction institutions, particularly those aimed at allowing economic agents, including the poor, to access product and factor markets, as well as ensuring the efficiency of rules and their non-discretionary implementation.

Developing countries often have inadequate, inefficient formal rules (for example, a contract law, tax laws, an election law, a constitution). Rules are inefficient because they are products of political competition aimed at short-run factional interests. More often, however, developing countries fail to enforce reasonably efficient formal rules. Western formal institutions, with their roots in individualism, transplanted to developing countries, often do not function as intended in a group-oriented culture. A result is a large and widespread discrepancy between de jure and de facto rules. The group-oriented social interactions that yield

factionalism are not only a political problem but also a cultural problem. Incompatibility between formal institutions and informal norms in developing countries is not a knowledge problem but a values problem. Discretionary rule implementation is not necessarily a result of bad intentions; it is often rooted in well-intentioned actions of paternalistic ruling élites.

This chapter combines the recent contributions of North (and other new institutional economists) and Hofstede (and other culture researchers) to suggest issues that need to be considered in building institutions for economic growth and poverty reduction. Defining institutions as rules, North has analysed their role in the economic performance of different societies through time. Hofstede (1997) has analysed different societies' dimensions of culture and their human behavioural implications. An integration of these contributions can provide a useful way to look at economic growth and poverty reduction processes.

The chapter has a twofold objective: (1) to analyse the implications of collective values for how human beings behave and how institutions function and (2) to identify issues that need to be considered in building transaction institutions in the countries that have not yet established mature market institutions. The aim is to assess the implications of a society's collective values for the operation and development of its economy and to suggest an approach to building institutions for growth and poverty reduction.

Section 2 reviews the empirical findings on the relationship between rules and economic growth. Sections 3 and 4 provide an overview of the findings of recent research on values and behaviour and suggest their economic implications. Sections 5 and 6 draw on this analysis and contemporary and historical experiences to identify issues that need to be considered in making and implementing rules for growth and poverty reduction in culturally collectivist societies. Section 7 provides conclusions.

2 Institutions as rules and economic growth and poverty reduction

Using a game theory analogy, North defines institutions in terms of formal and informal rules of the game for individual and organizational interactions. Formal rules include a legal system and policy measures; informal rules include norms of behaviour and self-imposed codes of conduct. Efficient rules, by providing proper incentives and establishing a

stable structure of human interactions, encourage individuals to engage in productive activities, thus promoting economic growth.

2.1 The process of institutional development

Explaining how institutions change is a demanding interdisciplinary task. The process of institutional development, largely based on North (1990, 1994), and drawing also on Hofstede (1997) and others, may be sketched as follows.

Beliefs, values and institutions

Institutional development is a learning process. Human beings learn by developing mental models and forming beliefs, through which they interpret their experiences. Shared mental models and beliefs provide a basis for a culture, which manifests itself in collective values (a broad tendency to prefer certain states of affairs over others), rituals (collective activities) and symbols (languages and other means of expression). Values can promote rational thinking; they can also create dogmas and prejudices (see North, 1994; Huntington, 1996; and Wilk, 1996). If a culture were a multi-layered sphere, values – both terminal (for example, regarding freedom, happiness) and instrumental (for example, regarding courage, honesty) – would be its innermost core; rituals and symbols its outer layers. Values change only slowly; symbols less slowly. Given their beliefs, human beings develop institutions to structure their interactions. Beliefs and institutions thus created are not, in and of themselves, efficient and growth promoting.

Institutional change and institutional entrepreneurs

Institutions change as a result of interactions among rules of the game, organizational or individual players of the game, and institutional entrepreneurs, who respond to various signals to bring about institutional innovations. The signals are not necessarily economic (a change in relative prices, for instance); ideas, as well as vested interests, matter. Interactions among institutional entrepreneurs and leaders of groups are important. Institutional entrepreneurs combine ideas and political visions to introduce sustainable, more efficient new rules (for example, a new constitution, tax law).

2.2 Stages of development of institutions for economic and political transactions

Through history, a country's transition to a mature market economy has passed through broadly two stages.

1. Transactions without adequate third-party enforcement

The development of institutions for economic transactions in this stage takes two phases. In the first phase, intracommunity transactions rely on personal ties.¹ Specialization is minimal and living standards are low. In the second phase, intercommunity transactions take place with inadequate intercommunity institutions. Political transactions also can take place without third-party enforcement. Political groups often engage in competition without a well-defined, tightly enforced legal framework (for example, an effective election law).

2. Widespread impersonal transactions with third-party enforcement

In this stage, a coercive government provides efficient institutions for impersonal intracommunity and intercommunity economic transactions throughout a nation-state. A low-cost transaction system provides opportunities for specialization. Legal and other rules with third-party enforcement also govern intergroup and intragroup political transactions. Political groups compete and transact within a framework enforced by a third party (North, 1990: 12).²

Game-theoretic characterization

Institutional development is a process of agents' learning to engage in transactions. Non-cooperative game theory offers two models to characterize the conditions underlying the operation of institutions in the first stage of institutional development, with no adequate third-party enforcement. The first model explains how intracommunity transactions take place when the game is repeated, when the players possess information about other players and when the number of players is small.³ The second model explains how intercommunity transactions take place relying on contagious punishments, in which a single member's violation of codes of conduct triggers a retaliation by opponent players against all members of the violator's community (for example, Kandori, 1992). These conditions are not easy to achieve for a large economic space. Widespread intercommunity transactions that allow efficient specialization are not feasible without transactions with third-party enforcement. Cooperative game models show that an enforceable contract can bring about Pareto-optimal improvement for the players engaged in a Prisoner's Dilemma.

2.3 Efficient rules and economic growth and poverty reduction

Only efficient institutions promote growth. Affluence in developed countries is a cumulative result of efficient formal and informal rules; poverty in poor countries, of inefficient rules. For institutions to function well, formal rules should be nested in hospitable informal rules (or norms), which provide legitimacy to them.

Rules versus discretion

To promote productive investments and other activities, rules (for example, laws, policies) should be stable, allowing economic agents to predict how these rules will affect the returns to their investments. To satisfy this requirement, rules should be interpreted and implemented without discretion, which creates a damaging environment for productive investments and other activities.

Rules and economic growth: Empirical studies

Recent research efforts have postulated and empirically estimated the relation between economic growth and measures of institutional efficiency. For example, the World Economic Forum (WEF) has assessed the economic growth prospects for each of the more than 50 countries in its database by using its competitiveness index, which reflects the country's institutional efficiency (Sachs and Warner, 1996). In a similar effort, Brunetti, Kisunko and Weder (1998) have postulated that economic growth is determined by the predictability of rules and a number of other more traditional factors, including educational attainment, inflation and trade.

Institutions and poverty reduction

A constraint on poverty reduction in many developing countries is inadequate, inefficient transaction institutions. For many smallholders and micro-entrepreneurs, inadequate access to microcredit institutions, in addition to inadequate skills, is a critical constraint on an increase in production. Small shopkeepers may not hire poor jobseekers because they do not have confidence either in the jobseekers' integrity or in the country's legal system. These are merely a sample of possible cases in which inadequate institutions are a critical constraint on an immediate reduction in poverty. In many cases, these are binding constraints.⁴

Unresolved questions

The formulations linking institutions to growth do not reveal how formal and informal rules are related. The strength of rules is simply a composite index of measures of the strength of individual rules. They do not suggest why some countries have been able to establish an effective rule of law, but others have not. Moreover, it is important to explore how developing countries should build (a) efficient institutions in general and mechanisms for ensuring their non-discretionary implementation and (b) transaction institutions that would allow smallholders, micro-entrepreneurs and impoverished jobseekers to access credits and product or labour markets.

3 The implications of collective values for behavioural norms and rules

3.1 *Determinants of human behavioural norms*

Three levels of uniqueness of human mental programming

Hofstede's (1997, 2001) extensive analysis of the world's cultures offers a useful approach to understanding why a rule of law prevails in some countries but not in others.⁵ Hofstede notes that there are three levels of uniqueness in human mental programming: human nature, culture and personality. Human nature is universal and is inherited. Culture is specific to a group (for example, an extended family, a political party, the alumni of a university, or the residents of a town or a country) and is learned.⁶ Personality is specific to an individual and is both inherited and learned.

Dimensions of culture

Hofstede's approach reduces the study of culture to manageable proportions by focusing on four quantifiable dimensions of culture: collectivism–individualism, power distance, uncertainty avoidance and masculinity–femininity. The analysis of these dimensions suggests channels through which culture affects human behaviour, with regard to relations among individuals, between individuals and groups, and among groups in their use of rules. This chapter focuses on only the first three, and particularly on the first two, relating them to economic growth: individualism–collectivism (IC) indicates the tendency for members of society to value individual interests over collective interests;⁷ power distance (PD) indicates the degree to which members expect and accept that power is distributed unequally; uncertainty avoidance (UA) indicates the degree to which members tolerate uncertainty.

3.2 *Collective values and general behavioural norms*

On the basis of surveys consisting of a series of questions, Hofstede (1997) estimates IC, PD and UA indices for 53 countries.⁸ One of his key findings is that the IC index is negatively correlated with the PD index, whereas the UA index is largely independent of both the IC and PD indices. The countries with an individualist (collectivist) culture tend to have a small (large) PD. Hofstede's IC index measures the degree of individualism in a society, a high index implying a high degree of individualism.⁹

Individualism–collectivism and power distance

Table 1.1(a) contrasts general human behavioural norms in a collectivist culture (and with a large PD) with those in an individualist culture (and with a small PD). The IC index suggests general behavioural norms of individuals in relation to their groups. These norms indicate that, in a collectivist culture (with a large PD), (i) members of society tend to value group interests over individual interests and to accept authoritarian and paternalistic leaders; (ii) personal ties among members of a group play important roles; (iii) personal rule, which is by nature discretionary, tends to prevail rather than a rule of law; and (iv) group rivalry and factionalism within a society are pronounced.¹⁰ By comparison, in an individualist culture (with a small PD), members of a group tend to value their own interests over group interests, to rely more on formal rules than on personal ties, and to prefer resourceful, democratic leaders. Those in authority are expected to lead by rules rather than by discretionary, paternalistic actions.¹¹

Uncertainty avoidance (UA)

The UA index indicates the extent to which individuals try to avoid uncertainty. In a culture with strong UA, people have an emotional need for rules and, therefore, tend to rely on formal rules, even if the rules do not work; their rules tend to be numerous and precise. In a culture with weak UA, by contrast, individuals tend to accept uncertainty and have relatively little need for formal rules (see Table 1.1(b)).

IC, PD and UA across countries

According to Hofstede, the PD and IC indices are negatively correlated. Generally, Western civilization countries have an individualist culture (a high IC index) and a small PD index. Countries in the rest of the world tend to have a collectivist culture and a large PD index.¹² Whereas collectivist countries tend to have strong UA, individualist countries are scattered over a wide range of the UA scale.

3.3 Cultural collectivism, a large power distance and rules

Cultural collectivism has clear economic implications.

Reliance on personal ties

Intragroup personal ties play an important role in economic, social and political interactions. Repetitively reciprocal transactions tend to be based on personal ties rather than formal and impersonal rules.

Table 1.1 Dimensions of culture and general human behavioural norms
 (a) Individualism–collectivism (IC) and power distance (PD) dimensions

	Collectivist/large PD	Individualist/small PD
<i>Interpersonal relationship</i>		
Individual identity	Based in the social network	Based in the individual
Virtues in interpersonal relations	Harmony	Speaking one's mind
Relationship and task	Relationship over task	Task over relationship
Inequalities among people	To be expected and desired	To be minimized
Prevailing ideology	Equality over individual freedom	Individual freedom over equality
Consequence of trespassing	Shame	Guilt
Privileges	Justified for the powerful	Not justified for the powerful
Communication	High context	Low context
<i>Relationship between individuals and group</i>		
Prevailing interest	Collective	Individual
Societal goals	Harmony and consensus	Self-actualization
Loyalty to group	Strong	Weak
Preferred organization	Centralization	Decentralization
<i>Intergroup relationship</i>		
Laws and rights	To differ across groups	To be the same across groups
<i>Leadership</i>		
Ideal boss	Benevolent autocrat	Resourceful democrat
Guiding value	Authoritarian	Democratic
<i>State</i>		
Role of state	Dominant	Small
Political power	Exercised by interest groups	Exercised by voters
Governance	Personal rule Discretion	Rule of law Rules
Sources of power	Ability to use force Family and friends	Ability to give rewards Formal position
Means of reform	Changing top people	Changing rules
Prevailing philosophy	Hierarchy and stratification	Equality

Ambiguous rules and discretionary rule implementation

Cultural collectivism can help members of a society avoid tragedies of commons. However, group-oriented values and discretion are often an obstacle to an effective system of well-defined property rights. They can

Table 1.1 (cont.)

(b) Uncertainty avoidance (UA) dimension

	Strong UA	Weak UA
<i>Dealing with uncertainty</i>		
Uncertainty	Feared	Tolerated
Rules (and laws)	Emotional need for rules, even if they do not work	Minimal need for rules
Innovation	Many and precise Resisted	Few and general Tolerated
<i>Truth and ideology</i>		
Truth	Absolute	Relative
Ideology	Nationalism	Internationalism

Source: Compiled from Hofstede (1997).

Note: Expecting inequalities among individuals prevails in a culture with a large PD, whereas the ideology of preferring equality to individual freedom prevails in a collectivist culture. Although prevailing values in culturally collectivist societies, in general, are compatible with those in societies with a large PD, these two values appear to be contradictory. Note, however, that the prevailing ideology compares equality with individual freedom, not a higher degree of inequality with a lower degree of inequality.

also be a source of discretionary enforcement by government of well-defined formal property rights. This can be true between the government and the private sector, among private groups, and within families. Governmental discretion discourages efficient transactions and can promote corruption.¹³

Governmental paternalism

A large PD index in a collectivist culture implies a tendency toward governmental paternalism.¹⁴ Paternalistic government, which under wise leadership can correct some market failures, not only justifies governmental intrusion into the personal activities of individuals but also gives rise to public expectations of paternalistic government intrusion. In South Korea, a culturally collectivist country with a large PD index,¹⁵ the government promoted industrialization through directed lending and other administrative support (Amsden, 1989). A direct governmental push for private entrepreneurs to commit to large investment projects inevitably creates expectations of a possible future bailout, leading to excessive investments supported by government-directed bank loans, low business profitability in certain sectors, and an accumulation of non-performing bank loans.

Group rivalry

Group orientation can mean intragroup cohesion,¹⁶ but it can also mean intergroup rivalry and conflicts. Consensus might not be easy to obtain because of the conflicts among different interest groups, whose respective members tend to have fierce group loyalty.¹⁷

Game-theoretic characterization

In Axelrod's tournaments of repeated games of Prisoners' Dilemma in which players are asked to choose either "cooperation" or "defection", the dominant strategy was Tit for Tat (TFT), a strategy of starting the game with a cooperative action but responding to the other player's action with the same action (Axelrod, 1984). Whereas Axelrod's experiments focused on individualist agents, who would apply TFT against each of their opponents without discrimination, other game-theoretic experiments have shown how the results would change when agents' behaviour is group oriented. Group-oriented agents would use Discriminatory TFT (DTFT) – a strategy of applying TFT against the members of their own group but opting for a defection against all outsiders all the time. Experiments have shown that DTFT is the dominant strategy in games of group-oriented players (Poundstone, 1992). Thus, individual agents in group-oriented societies have an incentive to be group oriented in addition to peer pressure, as discussed later in this chapter.

3.4 Rules and dimensions of culture: Illustrative cross-country analysis

If culture influences the effectiveness of the rules that govern a society, how strong is the statistical evidence? Tables 1.2 and 1.3 present the results of a statistical analysis that combines databases from Hofstede's measures of national individualism–collectivism, power distance and uncertainty avoidance indices and from the WEF's measures of three national indices of the effectiveness of rules: the effectiveness of the rule of law (represented by a composite index of judiciary independence, soundness of property rights and independence of the legal framework), the efficiency of government regulation (measured as the inverse of regulatory burden) and tax compliance (measured as the inverse of the degree of tax evasion). The sample comprises 42 countries for which data are available from both sources.

Overview: The West and the rest

Table 1.2 provides an overview of the averages for two country groups: the countries that belong to Western civilization and the rest of the

Table 1.2 Dimensions of culture and the effectiveness of rules

	Sample countries	Dimensions of culture			Effectiveness of rules		
		IC	PD	UA	Rule of law	Regulatory efficiency	Tax compliance
Mean		48.0		64.5	5.3	3.6	3.7
SD		25.6		24.3	1.1	0.7	1.1
Range		12–91		8–112	2.8–6.7	2.2–5.2	2.4–6.1
West	20–22	70	37	60	6.2	3.7	4.0
Rest	21–25	25	72	71	4.0	3.1	2.8

Sources: Hofstede (1997) and World Economic Forum (2000).

Note: The number of countries used for the averages varies across country groups and indicators. A high index = individualism is widespread in society; large PD prevails; strong UA; effective rule of law; high regulatory efficiency; high tax compliance.

world. The first three columns report the average IC, PD and UA indices; the second three report the average indicators of the rule of law, regulatory efficiency and tax compliance. The West has an individualist culture with a high IC index (70 versus 25) and a small PD index (37 versus 72). The West tends to have a smaller UA index (60 versus 71) and a higher rule of law index (6.2 versus 4.0) than the rest. These results are consistent with a higher index of regulatory efficiency (3.7 versus 3.1) and a higher index of tax compliance (4.0 versus 2.8).¹⁸ Western countries achieve higher tax compliance than the rest of the world despite higher statutory tax rates.

Rule of law

Equation (1.1) postulates that the rule of law (r) is a function of individualism (i):

$$r = f(i). \quad (1.1)$$

On the basis of Hofstede's analysis, countries with a high individualism index should tend to have a high rule of law index. Table 1.3 reports the results of regressions that postulate that the three indicators of the effectiveness of rules are explained by some of the dimensions of culture. Alternative functional forms yield statistically significant coefficient estimates with the correct sign. Individualism "explains" the rule of law with a large t -ratio for the coefficient and an adjusted R^2 exceeding .500.¹⁹

Table 1.3 Dimensions of culture and the behaviour of economic agents (42 individualist and collectivist countries)

	Explanatory variables						Adjusted R^2		
	Central tendencies of independent variables			Individualism	UA	Rule of law		Average statutory tax rate	
Mean	Mean	SD	Range	Constant	Individualism	UA	Rule of law	Average statutory tax rate	Adjusted R^2
SD					48.0	64.5	5.3	21.7	
Range					25.6	24.3	1.1	7.0	
					12-91	8-112	2.8-6.7	6.9-36	
<i>Dependent variable</i>									
Rule of law	5.3	1.1	2.8-6.7	3.659 (15.22)	0.034 (7.60)				.581
Regulatory efficiency	(1) 3.6	0.7	2.2-5.2	2.200			0.259 (3.02)		.165
	(2)			(4.76) 4.301 (15.57)		-0.011 (-2.84)			.147
	(3)			3.069 (4.64)		-0.008 (-1.79)	0.188 (2.04)		.209
Tax compliance	(1) 3.7	1.1	2.4-6.1	4.608				-0.043 (-1.78)	.050
	(2)			(8.38) 0.328 (0.51)			0.635 (5.31)		.399
	(3)			1.328 (2.15)			0.710 (6.74)	-0.064 (-3.80)	.429

Sources: Regressions based on data from World Economic Forum (2000) and Hofstede (1997).

Note: The two numbers reported for each explanatory variable and each equation are the estimated coefficient and associated t -ratio (in parentheses).

Regulatory efficiency and tax compliance

Equations (1.2) and (1.3), respectively, relate regulatory efficiency and tax compliance to cultural factors:

$$e = g(u, r) = g(u, f(i)) \quad (1.2)$$

$$c = h(r, t) = h(f(i), t) \quad (1.3)$$

Equation (1.2) postulates that regulatory efficiency (e) is a function of UA (u) and the rule of law (r). Countries with a high degree of UA would tend to have a complicated regulatory regime; however, an effective rule of law limits its negative effect on regulatory efficiency. The countries with no effective rule of law tend to use governmental discretion, which reduces regulatory efficiency. Equation (1.3) postulates that tax compliance (c) is a function of the rule of law (r) and statutory tax rates, represented by an average statutory tax rate (t). An effective rule of law would help a country increase tax compliance. However, other things being equal, high statutory tax rates would encourage tax evasion.²⁰ The estimation results support these hypotheses.

Reverse causation

The rule of law, high regulatory efficiency and high tax compliance are all-important foundations for economic growth. Therefore, the statistical analysis suggests positive implications of individualism for economic growth. However, one might ask whether causation runs in the reverse direction. Rather than individualism leading to a rule of law and economic growth, does economic prosperity provide a society with the resources to build a rule of law? Do economic growth and urbanization undermine group cohesion? Although these are plausible hypotheses, evidence indicates that the emergence of individualism in the West preceded economic growth. Symptoms of individualism in the West emerged as early as ancient Greece and biblical times (Frost, 1962: 179; MacFarlane, 1987: 196), although this intellectual development did not become a widespread belief. Anthropologist MacFarlane's (1987) research indicates that English society had manifestations of individualism in the thirteenth century.²¹

3.5 Questions

This section has argued that individualist and collectivist values have different behavioural implications. Research in game theory, however, raises important questions about the relevance of this distinction. Some game theorists (for example, Kandori, 1992) have advanced models

based on contagious sanctions to explain these intercommunity behavioural patterns for agents with individualist values.

Do human beings, by nature, pursue self-interest? This is the view of human beings in most economic models. This section argues that cultural values, which human beings acquire through learning, often lead people to behave differently in different societies. Individuals in culturally collectivist societies, although having varying degrees of self-interest, are guided by group-oriented values and their behaviour is constrained by social norms that stress the importance of group interests.

The individualist agents in Kandori's model, as well as agents in culturally collectivist societies, can use mutual contagious sanctions to sustain intercommunity transactions. This observational equivalence between individualist and collectivist societies in intergroup or intercommunity behavioural patterns, however, does not imply that the values and social norms do not matter. As Greif (1994) has shown, the intracommunity institutions in individualist and collectivist societies will differ from each other; the former would tend to rely on formal rules, the latter on personal ties.

There are other questions. How have some of the culturally collectivist countries achieved growth? Among the world's wealthiest countries and regions are Japan, Hong Kong's Special Administrative Region, and Singapore. Korea and Taiwan Province of China too have achieved impressive growth records. These countries are all culturally collectivist. In response to these questions, one should point out that growth is a multi-dimensional phenomenon. This section highlights the implications of (a) values for rules and (b) rules for growth. There are factors other than rules that affect growth and factors other than values that affect rules. Although a rule of law and rule-based transactions are critical for growth, so are human capital, high savings and work efforts. These countries' rules, at least some of them, must have been more efficient, transparent and stable than those in less prosperous countries. It is also obvious that many of these middle-income countries face challenging institutional reform tasks. Unless they successfully meet these challenges, they may not continue to enjoy sustained growth.

If a rule of law is essential for economic growth, but is not readily achievable in a collectivist culture, and if culture changes only gradually, can poor countries ever achieve long-term economic growth? Some have argued that culture should be changed. For example, Etounga-Manguelle (2000) advocates a "cultural revolution" in education, politics, economics and social life. In Japan, a prime ministerial commission notes: "we [Japanese] cultivated ethical norms extolling social and organisational harmony. Socioeconomic affluence and internationalisation, however, made it difficult to sustain such ethical norms unchanged . . . How can the

power of individuals be better utilised? ... Here we outline two essential changes. One is to change the methods and systems whereby citizens interact with society ... The other essential change is ... promoting individuality and individual initiatives" (PMC, 2000: 1–2).²²

One might argue that, with the process of globalization, cross-country cultural diffusion would lead to increasingly individualist tendencies in the developing world. However, it is not revolution but evolution that transforms world. However, it is not revolution but evolution that transforms culture, particularly the values that comprise its innermost core.²³ The diffusion will take time. Therefore, it becomes essential to explore the following questions: (1) How do developing countries with a collectivist culture cope with institutions inadequate to promote growth? (2) How do they build a system based on rules, rather than on discretion, while still remaining collectivist in their cultural orientation? (3) In particular, how do they build public institutions that can overcome group rivalry and factionalism in their culture?

4 Coping with inadequate transaction institutions for growth and poverty reduction

4.1 Developing countries: Institutional reality

Developing countries must go through a long process of institutional development. Establishing sound formal institutions takes time.²⁴ It requires technical expertise as well as social consensus; some institutions (for instance, an expanded social protection programme) require financial resources to become established. Although developing countries can import formal institutions from developed countries relatively quickly, intercultural transplantations of informal norms take much longer. This is the most difficult problem facing developing countries in establishing an economy based on rules and promoting economic growth.²⁵

Western industrial countries have developed their formal and informal institutions over several hundred years. The largely evolutionary nature of the development of formal and informal institutions in the Western world has ensured that they are mutually compatible. Imported alien constitutions, tax laws, election laws and other formal institutions in developing countries often clash with local values.

4.2 Coping with inadequate transaction institutions: Examples

Through history, societies have responded to institutional needs in a variety of ways with varying degrees of success. For example, agents began to form a network of personal ties. Following the breakdown of the

Soviet Union, many former Soviet countries, without effective market institutions, saw an emergence of business networks. The transactions among members of a network are essentially intracommunity in nature, even if the partners are geographically far apart (Kali, 1999).²⁶ These are not necessarily efficient and growth-promoting. There have been interesting episodes involving intracommunity enforcement for intercommunity transactions. The following episodes, wide apart in time and space, have remarkably common features:

Community responsibilities system (CRS)

During the commercial revolution, traders in European communities engaged in intercommunity trade, without formal intercommunity institutions, by relying on the CRS. For example, merchants in Genoa or Venice traded with merchants in Constantinople or London without an intercommunity legal contract enforcement system governing their transactions and without knowing the merchants personally. Under the system, a failure by a member of one community to honour contracts with a member of another community mobilized the latter community's collective sanctions against all members of the former community (Greif, 1997).²⁷

Grameen Bank

In Bangladesh, the Grameen Bank has successfully instituted a micro-financing programme by introducing groups of rural villagers to credits, step by step, through a learning process in a repeated borrowing-and-repaying game, in which members of a group provide one another with "peer support in the form of mutual assistance and advice" and "discipline" (Yunus, 1999). The Grameen Bank has relied on a mix of punishments, threats of punishments and incentives, as well as traditional and modern institutional approaches. For example, while relying on de facto cross-guarantees based on intracommunity personal ties and discipline for loan collection, the bank has rotated loan officers geographically to prevent them from developing personal ties with borrowers.²⁸

Chaebol system

A chaebol group in Korea is a collection of large and small, legally separate, vertically and horizontally linked corporations managed by a mix of hired and owner executives controlled by an owner-family, usually headed by a paternalistic chairman. A group's influence extends to a large number of small subcontractors and suppliers, which often have exclusive business relations with the group.²⁹ Chaebol groups were the means for Korean entrepreneurs to overcome the weakness of the Korean financial and other transaction systems.³⁰ Banks loaned to

chaebol firms partly because the banks and chaebol groups had an understanding that the firms belonging to each chaebol were collectively liable for their individual borrowings through cross-guarantees and chaebol chairmen's de facto authority over intra-chaebol financial transactions (Amsden, 1989). These and other advantages in accessing bank loans may have outweighed the inefficiency arising from excessive diversification and inadequate specialization. Chaebol groups benefit from vertical integration, through ownership and de facto control of marketing channels, suppliers and subcontractors.³¹

The emergence and operation of chaebol groups cannot be fully explained without discussing the role of cultural collectivism and a large power distance (PD) index. Chaebol chairmen tend to manage their groups in a paternalistic, discretionary and group-oriented manner. Owner-founders tend to hand over not only the ownership but also the management of their corporations – some of which operate globally – to their sons, not necessarily through a vigorous competition to choose the best managers.

Limitations of intracommunity enforcement mechanisms

The CRS could not support a broad expansion of trade in medieval Europe. As the size of communities increased, the system began to face a number of difficulties: the ease of falsification of community affiliation; adverse selection; and insufficient incentives for lenders to examine the creditworthiness of individual borrowers (Greif, 1997). Eventually, the system disintegrated as emerging nation-states provided effective inter-community transaction institutions. The Grameen Bank experience would not be effective in urban areas with weak personal ties among residents. The chaebol system has served useful functions in Korea's drive for growth. However, the system is now considered an obstacle to Korea's further economic development, which depends on whether Korea develops sound economy-wide institutions that promote low-cost transactions.³²

4.3 Lessons for promoting growth and poverty reduction in developing countries

Potential entrepreneurs and workers in developing countries suffer from not only limited skills but also inadequate access to banks, product and input markets, and employment opportunities. Consider the following common cases:

- A small farmer needs to buy some equipment but has to pay for it in cash, which may not be available until his next crop is harvested and sold.

- A skilled village artisan is unable to borrow money from a local bank to open a small shop because she does not have collateral.
- A shopkeeper in a small town wants to hire a part-time helper. Although several qualified candidates are available, she does not have any assurance that the candidates are trustworthy. As an insurance against employee misconduct on jobs dealing with cash or merchandise, some employers demand “collateral” from impoverished jobseekers. The virtual impossibility for jobseekers to satisfy this requirement is likely to result in failure of an employment contract to materialize.

Transaction institutions are not effective in emerging market economies even in modern sectors. (i) Their banking systems are weak, often with large non-performing loans. Capital markets are not well developed. Small and medium enterprises tend to experience severe obstacles in securing financing. (ii) Most developing countries face the need to reform corporate governance.

In these examples, ineffective transaction institutions are critical constraints on growth and poverty reduction. More generally, producers can rarely expand production and employment without engaging in exchange separated over time and space between the quid and the quo. Such expansion, however, inevitably gives rise to an increase in the need to extend or access credit.³³

Building transaction institutions as a repeated game

Grameen Bank experiences indicate for developing countries an approach to helping the poor establish access to credits, markets, inputs and job opportunities in the absence of efficient transaction institutions. Game theory suggests that governments’ policies should focus on providing an institutional framework for producers, borrowers and jobseekers to form small voluntary groups such as cooperatives. This framework should be aimed at (a) building a system of transactions as a repeated game and (b) promoting a system in which players (for example, cooperatives, their present and potential creditors, or employees and employers) have easy access to information on the overall performance of cooperatives, though not necessarily of their individual members.

The cooperatives, or cooperative-like groups, would not necessarily have a formal internal governance structure; their internal governance would be based on personal ties for cooperation, competition and mutual sanctions. The size of a group, therefore, should be small and transactions should build up gradually.³⁴

- The financial institutions should gradually increase the amounts of loans.
- Producers (for example, smallholders) should be able to increase their access to financial institutions or to product or input markets by

forming voluntary groups (for example, credit cooperatives), each comprising a small number of producers who are collectively liable for the credits extended to them.

- The members of cooperatives would be able to maintain their respective groups' credit standings through mutual sanctions based on personal ties.
- These schemes, although not so easy in urban areas, would be applicable to small shopkeepers and independent entrepreneurs.
- Employees' or jobseekers' small voluntary cooperatives or cooperative-like organizations, based on personal ties, could help poor workers secure jobs.

Using business groups for large-scale investments

Without the benefits of efficient institutions for intercommunity transactions, chaebol groups in Korea mobilized financial resources for large-scale investment projects by relying on informal arrangements that have proven useful throughout history. Other developing countries may have no choice but to use a similar system for large-scale investments. Yet the chaebol system is considered to have been, and to continue to be, inefficient. Moreover, directed lending and other interventionist policies that supported the chaebol system are becoming increasingly unviable under World Trade Organization rules. An effort to use a similar system should be complemented by an incentive system to minimize its inefficiency.

5 Issues for building public institutions

Formal institutions in many developing countries should be designed with an adequate recognition of how they will interact with informal norms, many of which have their roots in collective values. To this end, it is not enough to take into account human nature, which is universal. It is necessary to consider the dimensions of the culture of the country in which the formal institutions are to operate. Institutional challenges are twofold:

1. How do governments (or countries) design and adopt efficient rules?
2. How do they enforce the rules?

The remainder of this section addresses these questions in reverse order, focusing on several issues that need to be considered when building formal institutions in economies with a collectivist culture. Some of these issues do not emerge in economies with an individualist culture. The section's limited objectives are to highlight issues and to offer historical examples, not to offer a blueprint for reform.³⁵

5.1 Rule-making versus rule-implementing, collectivism and factionalism

A government demonstrates a commitment to rules by enforcing the rules consistently and in a non-discretionary manner. More realistically, it subjects itself to “a set of rules that do not permit leeway for violating commitments” (North and Weingast, 1989: 804). Based on this latter approach, an effective government uses at least two principles: (a) separation of powers and (b) checks and balances. A system of checks and balances forces the legislative, executive and judicial branches to be interdependent.³⁶ This system separates law-making functions from law-implementing functions. If laws were the only rules, this system would also help separate rule-making functions from rule-implementing functions. This formal system operates well when nested in individualism.

5.2 Checks and balances in a collectivist culture

In a collectivist culture, however, this system may not operate as intended for a number of reasons. First, a large threat to non-discretionary rule implementation often comes not only from the political party in power but also from other social groups, to whom members of different government branches have excessive loyalty arising more from party membership, regional or tribal affiliation or school ties than from their official duties.³⁷ This loyalty weakens the intended checks and balances in the separation-of-powers principle. Secondly, rule implementation is undermined by the fact that the functions of the executive branch often encompass both rule-making and rule-implementing. Finance ministries not only formulate rules (for example, tax policy, budget and regulatory measures) but also often implement them, although, in a formal sense, the real authority for their legislation belongs to the legislative branch. Without either a strong tradition of a rule of law or a transparent system of public monitoring of rule implementation, reasonably efficient rules that have been formulated with public scrutiny may be implemented through a series of non-transparent discretionary actions. The results are discrepancies between de jure and de facto tax, regulatory and other regimes of economic rules. How do culturally collectivist societies build a tradition of non-discretionary rule implementation?

5.3 Issues in institutional reform for non-discretionary rule implementation

To ensure non-discretionary rule implementation, the relationship between rule-implementing agencies and their rule-making counter-

parts may have to be redefined. Several issues should be considered here.

Separating rule-making and rule-implementing functions

Clearly, it would not be easy to separate all rule-making and rule-implementing functions into two mutually exclusive groups. It seems feasible, however, to isolate a set of critical rule-implementing functions. Here are only a few examples:

- The functions of government prosecutors, mandated with law enforcement, can be separated not only from law-making but also from law enforcement policy formulation.
- Tax administration can be separated from tax policy formulation and legislation.
- The agencies that implement regulatory measures (for example, anti-trust, banking supervision) can be separated from those that formulate these measures and send them to the legislative branch.
- Budget execution can be separated from budget formulation. A rule-making agency should cooperate with the rule-implementing agency; it does not appear to be essential, however, for them to be part of the same agency.

Ensuring checks and balances

If the principle of separation of powers is applied to making and implementing rules defined to encompass laws, policies and regulations, there is a case for institutionally separating the two types of functions – as the legislative and the executive branches are separated. In a society with a collectivist culture and a large power distance index, prosecutors may be unduly loyal to those who appoint them. This possibility may be reduced by making law enforcement offices autonomous from elected law-making officials but subject to strict performance standards and checks and balances aimed at limiting the opportunities to abuse their authority.³⁸ Autonomous agencies would have a greater chance of resisting the political pressure to use discretion in their administration of a regulatory, tax or budget policy regime.

The separation of rule-making from rule-implementing has received attention both in countries with an individualist culture and in those with a collectivist culture. Many countries have an independent civil service. For example, the United States introduced the Civil Service Commission, now the Office of Personnel Management, in 1883 to replace the “spoils system” with a “merit system”.

New Zealand’s public expenditure management system is based on separating the role of ministers, who are responsible for policy-making, from the role of departmental chief executives, who are in charge of

policy implementation (Scott, 1996; Lee, 1995). This system might not work well in a collectivist culture, in which rule makers are likely to be a source of discretionary rule implementation.³⁹ The basic approach, however, with some modifications, can be considered for developing countries.

In the new programme budget system in Brazil, a culturally collectivist country, a programme manager, who is in charge of implementing a budgeted programme, does not report to the line ministers who control the budgetary resources that are used as inputs for the programme. This system adds a layer of checks and balances in the process of budget execution, in addition to the one provided by parliamentary oversight.

A number of developed and developing countries have foreign nationals as heads of key policy-implementing agencies (for example, tax collection agency, central bank). Others have used foreign commercial firms for certain aspects of customs administration (for example, pre-shipment inspections). To an extent, these are aimed at enhancing *non-discretionary* implementation of rules (tax laws, monetary policy rule, customs laws) by mandating those without ties to domestic interest groups to implement rules.

Individualist societies try to ensure the political neutrality of some rule-implementing agencies (for instance, an independent judiciary and an autonomous tax collection agency).⁴⁰ Culturally collectivist societies require a more rigorous system of autonomy for rule-implementing agencies in areas for which such agencies are not required in individualist societies.

Making local rule implementation non-discretionary

In a collectivist culture, local government operations may be easily influenced by local interest groups with personal ties to local government officials.⁴¹ Although local political processes ought to dictate policy formulation, should local policy implementation in key areas be assigned to professional administrators independent of local political interests and without personal ties to interest groups, as in the case of central tax administration agencies in some countries that collect *local* taxes on behalf of local governments? These are important issues to consider in designing a system of non-discretionary local rule implementation.

Holding autonomous rule-implementing agencies accountable

It is not easy to determine the degree to which autonomous rule-implementing agencies should be independent. Should they be independent of ministers, of the prime minister or of the president? Different

countries will have different circumstances. A question is whether the possibility of their abuse of authority is more tolerable than elected officials' abuse of rule-implementing agencies' loyalty for their own political gains.

5.4 Making new rules to tame factionalism: Three historical episodes

Whereas rule implementation should be politically neutral, rule-making should be an outcome of political competition, which should be governed by efficient rules. Through history, building political institutions has challenged all societies.⁴² In the stories discussed below, stable frameworks for political competition have emerged from the interplay of not only vested interests but also ideas of both groups and individuals, including institutional entrepreneurs: Cleisthenes in ancient Athens, James Madison in Colonial America and Lee Kuan Yew in Singapore. New political institutions have effectively helped a society tame factionalism.⁴³ These stories represent historical episodes that this section presents to highlight one particular aspect of rule-making: the successful establishment of institutions for productive political competition in which rival political groups are induced to seek societal, rather than factional, interests. The section does not assess or judge the institutions in their entirety. None of them was free of problems, criticisms or controversies. For example, the constitutions of ancient Athens and Colonial America did not resolve the problem of slavery. Lee's emphasis more on order than on freedom has caused controversies.⁴⁴

Cleisthenes' constitution for ancient Athens

In 682 BC, Athens abandoned monarchy and adopted a government of elected officials (*archons*), but had serious economic, social and political problems – most of all, strife among tribes, between low-income groups and wealthy aristocrats, and among regions.⁴⁵ In 510 BC, Athens turned to Cleisthenes, the head of a prominent family, to lead a constitutional reform effort. Cleisthenes designed and implemented a constitution that dismantled traditional tribes with parochial interests and replaced them, for the purpose of political competition, with new artificial tribes (*phylae*) designed to represent broad societal interests.⁴⁶ The reform “transformed Attica from a country of squabbling ... geographic and economic interests ... preoccupied with zero-sum redistribution into the world's first democracy” (Mueller, 2001: 75). When accepted, the 500 councillors took the oath “to advise what is best for the state” (Hammond, 1986: 190). The several decades following the reform include the Athenian Golden Age.

James Madison and the US Constitution

Following the Declaration of Independence, the 13 American colonies clashed over regional and sectoral interests. Madison's role was critical in framing the US Constitution, including the crucial Bill of Rights. A guiding principle was to protect the constitutional process from factional influences. North stresses this aspect: "Thus Madison, in Federalist Paper Number 10, maintained that the constitutional structure was devised in 1787 not only to facilitate certain kinds of exchange, but also to raise the costs of those kinds of exchange that promote the interests of factions" (North, 1990: 47). As earlier pointed out, Madison's emphasis on rules, rather than the wisdom of leaders, should be noted.

Lee Kuan Yew and housing and electoral reforms in Singapore

When Singapore became an independent country, few believed in its viability as a country (Lee, 2000). Singapore is a culturally collectivist country, where Chinese, Malay, Indian, and other smaller ethnic groups comprise a diverse population. Racial strife was not uncommon. Establishing a rule-based economic system without abandoning a collectivist culture has been notable. Under Lee's leadership, the government actively pursued policies, formalized in a government white paper, to help Singaporeans put the interests of the nation above those of ethnic groups. At the same time, the government promoted the establishment of ethnically integrated neighbourhoods by using a system of quotas in distributing apartment units. To ensure that minority groups from ethnically integrated electoral districts are represented in the parliament, the government instituted a system of group representation constituencies (GRCs), which were created by amalgamating three or four single-member constituencies and then contested by candidate groups, each with three or four members. Each group of candidates had to include a minority candidate to receive the support of minority voters.

5.5 *The role of institutional entrepreneurs and values*

The role of institutional entrepreneurs

The three examples highlight the importance of ensuring that political competition promotes the interests of the society as a whole, rather than the interests of groups, factions, regions or sectors. To this end, the three countries adopted formal rules: a new constitution in ancient Athens and Colonial America and a new election law in Singapore.

In all three countries, institutional entrepreneurs played key roles. How did these institutional entrepreneurs emerge? It appears that, in all

three countries, political and social conditions allowed open, although not unlimited, competition. There was a relatively level playing field for competitors. In ancient Athens, some 80 years prior to the Cleisthenes constitution, Solon's reform had established, in what Aristotle called a mixed oligarchic-democratic system, an equality of political rights among all Athenians in the election of officials (Hammond, 1986: 162, 190).⁴⁷ The American colonies also had a level playing field for political competition. Most of the founding fathers in America had the best formal education locally available, but they were not "like anything that existed in ... Europe".⁴⁸ Singapore has become a merit-based society.⁴⁹

The role of values

Values also played a role. In a culturally collective Singapore, the government has intervened with paternalistic policy measures (for example, a residential quota system aimed at racial integration, electoral reform featuring GRCs and a government white paper stressing the value of national cohesion). In the West, the functioning of formal institutions has been reinforced by political values that have sought the will of the majority, while resisting "the tyranny of the majority" (Mill, 1859; quoted in Himmelfarb, 1982). These values have guided many politicians who "on behalf of principle and to defend the overall interest of the country, confronted the passion of ... a majority of the general public" (Neivins, 1956: xi).⁵⁰

5.6 Issues in rule-making

Although developing countries with collectivist values face a difficult challenge in establishing political institutions that can tame factionalism, the three examples of political reform, together with the findings of new institutional economics, suggest several issues for political reform.

How can political groups be formed to represent societal, not factional, interests?

The Cleisthenes reform institutionally ensured this outcome by forming artificial tribes. The US Constitution balanced the interests of the union and those of states by instituting, among other means, a Senate where small and large states are represented with equal votes. Madison (1787) drew the attention of the public to the harmful effects of factions (for example, "a landed interest, a manufacturing interest, a mercantile interest, a moneyed interest"). Singapore's governmental white paper stresses the importance of the national interests over factional interests. Its electoral reform protected the political rights of the ethnic minority groups by instituting GRCs.

Game theory suggests the following conditions:

- Competing political groups (for instance, political parties) and their members should be not only interested in long-term political payoffs but also able to define the future streams of their respective political payoffs.
- They should have a well-defined, enduring policy agenda – an identity or a label. A collectivist culture and a large power distance can be an obstacle to their establishing such an agenda. Between one election and the next, politicians may reorganize political groups and blur their political identities, making it difficult for political competition to be established as a repeated game.
- The number of competing political groups should be limited. Public choice theory offers some useful suggestions to this end. As Singapore's electoral reform has demonstrated, the design of an electoral system can influence the nature of political competition. For example, the number of competing political groups tends to be determined by "district magnitude", the threshold of representation, the threshold of exclusion and the definition of majority in the determination of election outcomes.⁵¹

How would political groups agree on the reform of rule implementation?

Clearly, rival political groups will not agree to adopt the system of rule implementation outlined in section 5.3 above unless they believe that the system will benefit them – if not now, over time. Conditions should be created for each competing political group to recognize that the discounted present value of the future course of its political payoffs is greater in the new regime than in all counterfactual regimes, including the status quo. A challenge is to identify and create these conditions.

How do countries establish a level playing field for political competition?

The soundness of political competition depends on the soundness of not only intergroup competition but also intragroup competition. In many Western countries, a key question now in this regard is campaign financing. In a collectivist culture, this is much more than a campaign financing issue: a high power distance index and the overwhelming advantage of established politicians can be an effective barrier to new politicians' entry into political markets. A simple term limit might not be an answer if it excluded incumbent, but best, candidates from competition.

6 Promoting efficient economic and political transactions

6.1 Transactions as non-cooperative games in a society with weak rules

Economic and political transactions either do not take place or break down because the three conditions mentioned in section 2.2 for successful non-cooperative games are difficult to establish. When such games take place, they often do so essentially as a series of suboptimal non-cooperative one-off games.⁵²

Standard game-theoretic analyses assume (among other conditions) individualism – a condition that does not exist in many developing countries. Are the results of such analyses relevant for culturally collectivist developing countries? They are definitively relevant for the games played by economic and other interest groups (for example, among groups of borrowers and lenders, rival political groups) in developing countries. What do game-theoretic analyses suggest for promoting repeated economic and political transactions?

6.2 Promoting cooperative dimensions in non-cooperative games

Axelrod's suggestions (1984: chap. 7) provide a helpful guide for a reforming government. The ideas in this section are based on his suggestions.

Make the future count

In Axelrod's terminology, this is "enlarging the shadow of the future". A reforming government can take two practical steps: making interactions durable and making them frequent. The Grameen Bank's microcredit programme has these elements. Promises of rewards, provided in addition to threats of punishments, make productive interactions durable.

Set payoffs appropriately

The penalties for the violators of rules should be sufficiently large. Many banks impose severe punishments (for instance, cutting off credit lines, demanding an unusually high interest rate) for delayed loan repayments. The government in many well-functioning economies imposes credible penalties for the violation of tax and other laws. The government in poor countries often has an ineffective tax system that offers real benefits to late payments.

Make the players' past records in effect available to all players

Axelrod suggests improving "the ability [of players] to recognise the other players from past interactions, and to remember the relevant

features of those interactions” (1984: 139). More broadly, the government can help disseminate such information. For example, the government can promote private organizations that would make borrowing groups’ credit histories in effect available to all microcredit suppliers. The transaction system’s focus on groups, as suggested in this chapter, rather than on individuals, would be less taxing for developing countries with limited administrative resources.

7 Summary and conclusions

Economic prosperity in the Western developed countries is a result of sustained economic growth, which has been based in part on their efficient institutions, or rules, encompassing, among other things, an efficient transaction system supported by an effective judicial and political system. Certain dimensions of culture, such as individualism–collectivism, power distance and uncertainty avoidance, affect the efficiency of rules. In particular, individualism has been a critical factor helping a country to establish and maintain rule-based transactions. Cultural collectivism in most developing countries tends to promote the use of discretion and to undermine rules.

History provides developing countries with important lessons for promoting growth and reducing poverty. Before they reach the final stage of institutional development, in which efficient third-party enforcement supports widespread transactions, they can benefit from arrangements that have promoted intercommunity transactions without strong intercommunity transaction institutions. The experiences of the community responsibility system, the Grameen Bank and the Korean chaebol system suggest useful interim steps toward establishing transaction institutions for economic growth. The lessons should guide efforts to develop microcredit programmes, to increase small farmers’ access to product and input markets, to provide the unemployed poor with job opportunities and to enable large enterprises to mobilize capital in the absence of sound financial institutions. It is important to note, however, that these arrangements have critical weaknesses and eventually must be replaced with more efficient institutions.

In building efficient public institutions in a collectivist culture, it may be useful to make a clear distinction between rule-making and rule-implementing and to identify groups of important rule-implementing functions of government. Examples include law enforcement, tax administration and budget execution. To promote non-discretionary rule implementation, developing countries may consider mandating only some

organizations with these rule-implementing roles and making them autonomous from interest groups and even from elected government officials. Of course, these organizations must be held accountable to the public via strict and transparent performance requirements. They should have well-defined and accountable selection and removal procedures for their officers.

Legislation, policy formulation and other rule-making must be an outcome of a political process, which can be considered a process of games. Political reform in a collectivist culture should be aimed at taming factionalism and at promoting the interests of the whole society, rather than of factions, sectors or regions. The assumptions of individualism and rationalism underlying game-theoretic analysis extend realistically to games among competing groups in a culturally collectivist society. Therefore, the conclusions of game-theoretic analysis can provide a useful guide for institutional reforms in a collectivist society, which should aim its reform efforts at lowering barriers of entry for competitors into political markets. Political reform should be designed to provide a framework within which competing political groups can play a repeated game as a learning experience. To this end, the examples of ancient Athens, Colonial America and contemporary Singapore provide good lessons. If building institutions is a game and a learning process, it is important to pay attention not only to what institutions are to be built but also to how to build them.

The Grameen Bank experience offers interesting pointers. The Grameen Bank started to lend small amounts and gradually increased the amounts as borrowers accumulated credit rating. The Grameen Bank and its borrowers played a repeated learning and lending–borrowing game. The collective punishment scheme was nested in the collectivist culture of Bangladesh society.

The particular values discussed in this chapter are only a part of the systems of values guiding human behaviour in different societies. The chapter has not judged these values, but has offered an analysis of the economic implications of these values. Economists and other social scientists should more explicitly integrate these implications into their analyses of economic growth and poverty reduction. Rule-making should also take them into account.

Appendix

Table 1A.1 Country groups by individualism–collectivism (IC) and power distance (PD) indices

	Large PD	Moderate PD	Small PD
<i>Individualist</i>		Australia (90, 51)	United States (91, 40) United Kingdom (89, 35) Canada (80, 39) Netherlands (80, 38) New Zealand (79, 22) Denmark (74, 16) Sweden (71, 31) Ireland (70, 28) Norway (69, 31) Switzerland (68, 34) Germany (67, 35) Finland (63, 33) Austria (55, 11) Israel (54, 13)
	Belgium (75, 65) France (71, 68)	Italy (76, 50)	
		South Africa (65, 49)	
		Spain (51, 57)	
<i>Collectivist</i>	India (48, 77) Brazil (38, 69) Turkey (37, 66) Greece (35, 60) Philippines (32, 94) Mexico (30, 81) Portugal (27, 104) Malaysia (26, 104) Hong Kong (25, 68) Chile (23, 63) Singapore (20, 74) Thailand (20, 64) Korea (18, 60) Taiwan (17, 58) Peru (16, 64) Indonesia (14, 78) Colombia (13, 67) Venezuela (12, 81)	Japan (46, 54) Argentina (46, 49)	Costa Rica (15, 35)

Source: Hofstede (1997).

Note: The first figure in parentheses indicates the IC index; the second the PD index. A high IC index indicates a high degree of individualism.

tion to a number of important related papers and for giving me helpful comments, which have persuaded me to shorten and revise the chapter substantially. This chapter expands on a speaking note I used for a seminar held with a group of visiting economics and public administration graduate students from Ewha Womans University (Seoul, Korea) at the International Monetary Fund in August 2000. The views expressed in the chapter are strictly personal and not necessarily those of the IMF.

1. A “community” is a group of individuals with personal or other ties (e.g. kinship, friendship, or acquaintanceship). A community may be large (e.g. a town) or small (e.g. families).
2. Historically, traders often relied on private third-party enforcement mechanisms (e.g. law merchants, or *lex mercatoria*). But law merchants were not an adequate substitute for coercive governmental enforcement (see Aoki, 2001).
3. See Romp (1997) for a discussion of cooperative and *non*-cooperative games. In the context of banking, Greif (1997) has stated these conditions more formally: a game of exchange is possible if (a) it is repeated infinitely, (b) borrowers have a “label” known to all the lenders, and (c) each player’s past actions are known to all.
4. See Ray (1998: chap. 8) for a discussion of the failure of credit, insurance and labour markets for the poor in developing countries. Note how, for example, a shopkeeper and a jobseeker with inadequate nutrition, in a situation of a game of Prisoner’s Dilemma, may fail to agree on mutually beneficial long employment because of the absence of proper institutions. Quite often the analysis of poverty focuses on what is happening (e.g. the effect of malnutrition) but not on what could happen (e.g. the potential effect of institutions that would help the poor worker secure a job and build up his or her nutrition).
5. Hofstede’s work in the 1980s, building on the work of anthropologists, sociologists and psychologists, has given rise to extensive research in cross-cultural psychology (see Berry et al., 1992).
6. Individuals are members of overlapping groups. Heyer, Stewart and Thorp (1999) note the importance of group behaviour for development, focusing on the implications of *intragroup* operational modes: power/control (P/C), quasi market (M), and cooperation (CO-OP). P/C is associated with a large power distance, M with individualism and CO-OP with collectivism, although Western values (e.g. golden rule, categorical imperative) are not incompatible with the CO-OP mode of operation. These three modes are in line with those (despotic, super-trader and glued-together) associated with Sen’s suggested approaches to analysing the operation of families – the most basic of all groups (Sen, 1983).
7. The term “collectivism” indicates a group-oriented value system and refers in this chapter to a cultural phenomenon, not to a system of collectivized production. Rand (1943) has used the terms “collectivism” and “individualism” similarly.
8. Examples of questions for measuring individualism–collectivism (IC) indicators for individuals include the following: (i) “If the group is slowing me down, it is better to leave it and work alone” (individualism); (ii) “I enjoy meeting and talking to my neighbours every day” (collectivism); (iii) “It is reasonable for a son to continue his father’s business” (collectivism) (Berry et al., 1992; Triandis et al., 1986, 1988; Hui, 1988).
9. The indices are national tendencies, around which individual indices are distributed. Hofstede (1997, 2001: 86) bases his measures on mean scores of sample individuals and percentages of certain responses. Others (e.g. Triandis et al., 1986, 1988; and Hui, 1988) have developed individual-level scales to place persons on the collectivism–individualism dimension. Note that the discussion is on behavioural norms; actual behavioural patterns deviate from these norms.
10. Cultural collectivism is widespread. For example, see the definition of shared values in a

Government of Singapore white paper, quoted in Huntington (1996: 319): “Nation before [ethnic] community and society above self ... Consensus instead of contention”; and Etounga-Manguelle (2000: 71): “If we had to cite a single characteristic of the African culture, the subordination of the individual by the community would surely be the reference point”.

11. Individualism is deeply ingrained in Western thought. See Rawls (1990: 24–25): “Each member of society is thought to have an inviolability founded on justice ... which even the welfare of every one else cannot override”; and Rand (1943: 678): “His truth was his only motive. His own truth, and his own work to achieve it in his own way.” Economics has based its analysis on self-interested economic agents. Drawing on evolutionary biology, some researchers in evolutionary economics, however, note the role of biological and cultural “relatedness” among gene-sharing (e.g. kins) and other members of a society (Hirshleifer, 1999).
12. See tables 1A.1 and 1A.2 in the appendix to this chapter. Table 1A.1 classifies the sample countries by their IC, PD and UA indices. Belgium and France are the only Western, developed countries with large PD indices. Costa Rica is the only country in the rest of the world with both a collectivist culture and a small PD index.
13. The Chinese phrase “eating from one pot” characterizes economic, social and political interactions in Sinic and other civilizations with a collectivist culture. See Ensminger (1997) for a discussion of the factors arising from social norms that underlie the failure of land titling in Kenya.
14. Paternalistic attitudes do not necessarily belong only to government. Postbellum southern plantation owners in the United States relied on paternalistic labour relations to sustain non-mechanized agriculture (Alston and Ferrie, 1996).
15. Focusing on long-term issues, this chapter characterizes the Korean government’s policies during the past 30–40 years. The Korean government has been pursuing a range of economic reforms, and some of the policies described in this chapter have been abandoned or modified. The slowness with which values change, however, can frustrate a government’s reform efforts.
16. Confucianism formalizes a group-oriented social and political order dominated by wise, paternalistic leaders. Thus, Confucius’ ideals stress personal cultivation as the basis of a world order: “Confucianism traced back the ordering of a national life to the regulation of the family life and the regulation of the family life to the cultivation of the personal life” (Lin, 1938: 21). Note that these are ideals, not necessarily realities. It appears that Confucian societies, and culturally collectivist societies more broadly, continue to stress unduly the importance of the roles of wise leaders; this is in contrast to the tradition of scepticism about such roles in the Western world. For example, Madison (1787), in a strong rejection of discretion, stated: “It is in vain to say that enlightened statesmen will be able to adjust these clashing interests, and render them all subservient to the public goods. Enlightened statesmen will not always be at the helm.”
17. The strength of group loyalty would tend to aggravate the conflicts of different groups’ interests. Stewart (2001) has pointed out the possibility that horizontal inequalities – inequalities among cultural groups in a society – may be a source of development disasters.
18. By comparison with the large difference between the rule of law and tax compliance indices for the two country groups, the difference between the regulatory efficiency indices is not large. Note, however, that Western countries tend to have an elaborate regulatory regime aimed at achieving product safety, antitrust, environmental protection and other public policy objectives. Moreover, they have a high statutory tax burden, which tends to encourage tax evasion. Considering these circumstances, the difference in the tax compliance indices between the two country groups is considerable.

19. The estimation results are robust. Using each of the three components (for judiciary independence, soundness of property rights and independence of the legal framework) as the dependent variable, rather than the composite rule-of-law index, still gives strong statistical results.
20. Results, not reported in this chapter, show that regressions conducted on a subsample of 21 culturally collectivist countries (i.e. countries with an IC index of less than 50) are not qualitatively different.
21. Greif (1994) also indicates that individualism characterized the social norms of medieval Genoa.
22. See also Morishima (1988) for a discussion of how Japanese are good competing in groups but not as individuals.
23. Psychologists often distinguish between enculturation (cultural diffusion between generations within a culture) and acculturation (cultural diffusion between cultures). Acculturation is a slow process (Berry et al., 1992). New rules change human behaviour through compliance, identification and internalization. Cultural diffusion would not be complete, however, without internalization (Lieberman, 1963).
24. Li (2000) distinguishes between “relation-based governance” and “rule-based governance”. Moving from the former to the latter is a long tortuous process.
25. See Hamdok (2001: i) for a discussion of how “the recent emphasis on governance in Africa is unique in that it was initiated by donors and not by domestic leaders under pressure from their own constituencies”. Aoki (2001) contrasts the view of institutions as a “spontaneous order”, as discussed by Hayek (1988), with the view of institutions as artificially designed. The transplanted formal institutions in developing countries often have the characteristics of the latter.
26. In some transition economies, networks, clans and other informal groups play a range of roles, which include appropriating the state and, in some cases, forming a “clan state” (Wedel, 2001). These groups differ in nature from tribal or regional groups that give rise to civil war and other conflict (Addison, 2001), but are more likely to emerge in culturally collectivist than in individualist countries. Barr (2000) discusses Ghanaian entrepreneurial networks, which are largely bilateral.
27. See also Greif (1994), who associates collective punishments more generally with a collectivist culture. Greif’s analysis also shows that some medieval communities were collectivist whereas others were relatively individualist in their cultural orientation, and that the collectivist transaction institutions are more efficient in supporting intra-community transactions – requiring less costly formal institutions – but less efficient for intercommunity transactions (Greif, 1994: 942).
28. Yunus (1999: 93) stresses the importance of “the power of peers. . . . If one member fails to repay a loan, all members risk having their line of credits suspended or reduced.” Borrowers are required to join the bank in self-formed, five-member groups. “A new group submits loan proposals from two members, each requiring between \$25 and \$100.” The Bank used threats of collective punishments, but these have rarely been carried out (see Dowla, 2000).
29. See Amsden (1989: 184–188) for a discussion of the close and exclusive ties between the Hyundai Motor Company and some of its legally separate subcontractors.
30. Since the 1977–1978 financial crisis, the chaebol system has been undergoing changes, partly as a result of the Korean government’s effort to reform banking and corporate financing and governance.
31. For the firms in a chaebol group, weak transaction institutions in Korea elevate the costs of market transactions relative to the costs of internal governance. See Williamson (1985) for a discussion of the efficiency of hierarchical transactions relative to market transactions in driving vertical integration, and of the relationship between the costs of

internal governance and market transactions. As Hart states, “ownership is a source of power when contracts are incomplete” (1995: 29). Firms acquire other firms partly because the power will enable them to internalize transactions.

32. It is not strictly correct to characterize the CRS, Grameen Bank and chaebol–bank relations equally as responses to a failure in intercommunity transaction institutions. The CRS functioned with no intercommunity institutions. The successful loan management record of the Grameen Bank has been attributed more to its policy of requiring borrowers to be jointly liable than to an effective legal system. The chaebol–bank relationship is subject to a multitude of laws in Korea; however, there is an agreement that commercial banking requires reform, which is now a key challenge facing Korea.
33. The only type of transactions that would not require contracts or transaction institutions would be spot transactions for a good whose quality is known. Weak transaction institutions would limit even spot trade if the transacted goods are of unknown quality.
34. These groups would have only one function: cross-guaranteeing among one another for their intergroup transactions. Chaebol-like larger groups would have a range of functions, as is the case with many groups that emerge in developing countries. See Agarwal (2000) for a discussion of some of them.
35. In this section, rules refer to formal rules, unless otherwise indicated. It is worth noting, however, that rules have a hierarchy. Buchanan (1987) makes a distinction between the constitution of economic policy and economic policy. The former provides basic rules (e.g. a constitution, central bank law, budget law) for making specific rules (e.g. monetary policy, fiscal policy). Buchanan refers to the former as rules, but not the latter.
36. The English idea emphasizes impartial administration of laws through the separation of powers between law-making and law-implementing, whereas the American idea emphasizes checks and balances, particularly constraints imposed on law-making by the judiciary (see La Porta et al., 2001). This section stresses (a) the similarities among Western rules of law and (b) the discrepancy between de facto and de jure legal institutions in poor countries.
37. Public choice theory suggests that an independent civil service can make it difficult for an elected government to pursue promised policies (see, for example, Tullock, 1987). In countries with a collectivist culture, however, bureaucrats’ excessive loyalty to elected politicians can be a source of discretion in rule implementation.
38. In the United States, federal judges are appointed for a lifetime tenure and cannot be removed from office without an impeachment and conviction. In culturally collectivist countries, judicial independence might not be sufficient for efficient law enforcement.
39. See Bale and Dale (1998) for the demanding conditions that must be satisfied for a successful New Zealand-type reform: a consistent, comprehensive conceptual model; a clear performance definition; and a focus on what government does best. Schick (1998) suggests that a successful New Zealand-type reform should follow basic reforms to strengthen rule-based government.
40. The regulatory agencies in the United States are intended to be independent of the political goals of a particular president, and the heads of many regulatory agencies cannot be removed from office by the president unless for breaking the law. The data on legal institutions reported in La Porta et al. (2001) indicate that many developing countries, which may not have a firmly established rule of law, have a legal system based on the lifelong tenure of supreme court justices, suggesting that lifelong tenure of law-implementing officials may not be a sufficient condition for a rule of law.
41. This system would be in line with the Grameen Bank’s policy to rotate loan officers throughout the country regularly to prevent them from developing personal ties with local borrowers.

42. See North (1998) for a discussion of how competition among, as well as within, evolving nation-states determined the features of economic development. Competition among states forced some of the crowns to trade rights and privileges. See also North and Thomas (1973).
43. In this chapter, “societal” interests are used to indicate the broader interests of society, compared with the interests of individuals or individual groups. Although individuals and groups may not agree on a social welfare function, a distinction is often made between private and public interests, as well as between individual and social rates of return.
44. Kissinger, in his foreword to Lee’s volume, notes Lee’s “analysis of the difference between the individualism of the west and the priority for social cohesion in countries such as his and in much of the rest of Asia” and the criticism that Lee’s view based on this analysis has aroused in the West. Lee stresses fundamental differences between East Asian and Western societies, the former believing that “the individual exists in the context of the family, extended family, friends, and wider society . . . These values make for a productive people and help economic growth” (2000: 491). Sen (1997: 34) argues that the “Lee hypothesis” is based on limited information: “Systematic empirical studies give no real support to the claim that there is a general conflict between political rights and economic performances.”
45. This summary is largely based on Mueller (2001) and Hammond (1986).
46. For details, see the longer version of this chapter (WIDER Discussion Paper 2001/98).
47. Greek historians have described the openness of political competition in ancient Athens around that century. For example, Book II of Thucydides includes “The Funeral Oration of Pericles”, which, delivered about 80 years after the Cleisthenes’ reform, includes the following passage: “If we look to the laws, they afford equal justice to all in their private differences . . . if a man is able to serve the state, he is not hindered by the obscurity of his condition” (see Finley, 1959: 267).
48. “All of its members, not just those like Benjamin Franklin and Alexander Hamilton with famously impoverished origins, would have languished in obscurity in England or France” (Ellis, 2000: 11).
49. Lee (2000: 59) describes the openness of competition in selecting the senior officials of the Economic Development Board.
50. Kennedy (1956) stresses the importance of US senators viewing issues from national perspectives. His volume includes accounts of American politicians (e.g. Daniel Webster, John Quincy Adams, Robert Taft) who, in pursuit of their conviction, risked their political careers by defying the popular will of their constituencies.
51. See Grofman and Reynolds (2001) for a review of the main findings.
52. Transactions in developing countries often have elements of the Prisoners’ Dilemma game. Outside their communities, buyers and sellers are reluctant to offer credits or employment contracts because they do not consider their relations will continue, although doing so would pay off to all players in the short run, as well as over time. Political parties often prefer a status quo rather than agreeing on reform legislation that would benefit the society over time.

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Perspectives on Growth and Poverty

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The relationship between growth and poverty lies at the heart of development economics. While many see aggregate growth as both necessary and sufficient for reducing poverty, and consequently focus their efforts on achieving the desired macroeconomic outcomes, others stress that the benefits from growth may not be evenly spread. In fact critics of globalization often point out that growth of the macroeconomy may well have an adverse effect on the most vulnerable members of society. Thus the distributional impact of growth, as well as its level, needs to be taken into account when considering the consequences for poverty.

The importance of this topic, and the continuing controversies surrounding it, prompted United Nations University World Institute for Development Economics (UNU/WIDER) to organize a major academic conference on growth and poverty in May 2001. Its purpose was to review current thinking on the issue, to stimulate fresh research, and to allow researchers from various backgrounds to exchange ideas on future policy directions.

Perspectives on Growth and Poverty contains an important selection of the conference papers. They deal with institutional and policy questions, as well as sectoral issues and individual country experiences that illustrate the broad range of objectives and topics. One set of conclusions to emerge is that initial conditions, institutions, specific country structures, and time horizons all play a significant role.

The country- and context-specific nature of these factors point to the need for creative national solutions to the problem of poverty. This in turn requires an informed policy debate within countries: one which may hopefully lead to a consensus between different interest groups or at least help to clarify the basis of opposing views. The aim of this book is to stimulate and enhance this debate.

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