The Political Economy of Good Governance

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Abstract

In recent years there has been a marked increase in interest in what constitutes good government, good governance and quality of government. In addition to a broad consensus that government is no longer the key player in governing the economy, a concern has emerged that pursuing economic growth alone will not generate the best outcomes for society. In this paper we examine these questions through a political economy model of governance in which power, economic payoffs and governance arrangements co-develop. Using this model we explore how corruption and ignorance affect the two underlying political economy problems of wealth generation and wealth distribution. We show, as other authors have done, how corruption generates outcomes that fail to grow the pie, while at the same time generating distributional outcomes that are highly disadvantageous. We then show how ignorance can have one of two effects, depending on the context. In the one case, ignorance—through its impact on transaction costs—can result in a failure of the pie to grow, often with detrimental distributional impacts. In the other case, ignorance can lead to increases in the size of the pie, albeit at the cost of redistributing the benefits of this growth to a particular group to such an extent that political instability ensues.

The Political Economy of Good Governance

Introduction

The last twenty years have seen a burgeoning interest in what constitutes good government, good governance and quality of government. A good deal of this enthusiasm for "governance" is a product of a diminished faith in constitutionally mandated public authorities. As the 20th century drew to a close, the rise of new governance relationships such as New Public Management reflected a belief that the state's monopoly on coercion did not translate smoothly into a monopoly on knowledge, expertise or judgement. By 2000 a broad consensus had emerged that government was no longer the "cockpit from which society is governed" (Klijn and Koppenjan 2000, 135).

The making and implementing of policy is now shared among a variety of state and non-state actors, and the concept of governance has quickly become a means of capturing shifts in the locus of authority between, for example, the state and markets, politicians and experts, bureaucrats and stakeholders (Levi-Faur 2012). How to steer and control government was no longer the only topic or issue for students of public policy. Instead, productive and efficient exchange among old and new, sometimes hybridized, entities began to loom large as an object of governance. Concepts like "network governance" were introduced to capture these developments, while concepts like "global governance" and "multilevel governance" reflected the growing importance of regulatory and financial relations among governments.

In line with this focus on relationships and the organization of systems in a productive manner, the concept of good governance was embraced by international agencies (e.g., the World Bank) and the private sector as a signal of the likelihood of a country, and particularly a developing country, achieving economic growth and societal well-being. In this case, a key question was whether those with power and influence in the country would pursue policies that would achieve there objectives.

A flood of metrics has been proposed to estimate the extent of good governance in different countries, with the allocation of aid by the international donor community and investment by private sector firms frequently premised on these indicators.

More recently an additional issue has emerged in the governance discussion. The key question in this case is largely focused on developed countries and is concerned, not with whether growth will occur, but whether growth can be made inclusive. As the OECD (2017, 1) comments, "We are at a critical crossroad. For years, we counted on economic growth as the only engine of prosperity, failing to realise that this model was leaving many behind; specifically the bottom 40%. In a context where global markets and increased connectivity of economic structures were skewed to benefit a minority of people and firms, disempowered citizens and communities called a halt." To pursue both growth and inclusiveness, the OECD is calling for a "profound reappraisal of the policy making process."

These observations prompt the questions: What does it mean to talk about "governance arrangements?" What is "good governance?" And how does this relate to policy? On the first point, all definitions of governance refer, directly or indirectly, to rules that determine the exercise of authority in the taking of collective decisions. While a more detailed definition will be given below, for now it is sufficient to note that governance arrangements stipulate, more or less precisely, how various voices are heard, how decisions are made and how accounts are rendered (Institute on Governance 2017). In short, governance defines who has the power to determine what.

From this common definitional base, students of governance have proceeded in a number of different directions depending on what they believe to be the most pressing problems that governance arrangements are intended to solve. Our position is that governance has to deal with two key issues that have long been the focus of attention in political economy—income and wealth generation (how to enlarge the pie), and income and wealth distribution (how to distribute the pie).

These two issues correspond roughly to the purpose of economics—the creation of wealth—and the purpose of politics—the orderly resolution of conflict. As can be seen from the OECD quotation above, a reappraisal is currently underway as to the relative importance of these two issues.

Addressing these two problems requires the need to deal with two apparently chronic conditions in public affairs: corruption and ignorance. Of these two, corruption has received the most attention. Corruption, as distinct from negligence or incompetence, does not simply happen; there is a strong volitional component. Corruption occurs when public officials—be they elected or appointed—set aside their formal, office-defined, responsibilities to pursue some form of personal advancement defined broadly enough to include the advancement of one's political and personal interests as well as the interests of friends, relatives and associates. In the case of grand corruption, it is the abuse of power by elites that is important, as elites change the rules of the game in a way that benefits them (both financially and in terms of obtaining and consolidating power) (Atkinson 2011a). In the case of petty corruption, it is the abuse of power by officials at key points in the bureaucracy as they withhold or provide services that creates the opportunity for bribes and payments (Shleifer and Vishny 1993).

Ignorance has a number of dimensions. It can refer to an inability to acquire and apply readily available knowledge to decision situations—in this sense ignorance can be equated with incompetence and perhaps even negligence. Ignorance, however, can also be based on a calculated and rational choice to decline to be informed—if this ignorance provides personal advancement then it shares some aspects with corruption.

More interestingly, perhaps, ignorance can also arise from the absence of available information or knowledge. Understood this way, ignorance is often a function of uncertainty, the inability to accurately anticipate the probabilities of outcomes given some action. Ignorance in this second sense is compounded by biases. As a result of biases, citizens and leaders look for evidence that confirms positions they already hold, place a higher value on their current positions than is objectively justifiable and overweight the evidence most recently obtained (Kahneman 2011, Kahneman et al. 2011). Like the rest of us, policy makers look for reasons to believe their initial hunches are correct and reverse preferences depending upon how options are presented. In addition, we draw conclusions based on personally evocative but statistically dubious evidence, sometimes referred to as "probability neglect" (Brest, 2013: 487).

One of the most significant problems to emerge as a result of this second form of ignorance is the persistent hold that the status quo has on policy makers, and indeed the general public. Whether as a result of institutional norms that straightjacket people's thinking or cognitive loss aversion, there is a plethora of ways in which full and complete knowledge of the situation is not brought to bear on a problem. The results are lost opportunities and/or inappropriate responses to the problems at hand (Atkinson 2011b).

The working hypothesis of governance research is that some governance arrangements are better than others at dealing with corruption and ignorance. More specifically, the problem with corruption and ignorance is that they produce bad policies – i.e., policies that fail to improve the lives of the people in a country. Indeed, our view is that governance is a popular concept (and likely to remain so) in part because of its normative orientation. It is not necessary to add the word "good" to governance to appreciate that its students and practitioners are interested in both assessing and reforming current governance arrangements. In short, governance is a concept pregnant with ideas for reform; the term "good governance" makes these implicit normative commitments explicit.

This normative dimension shows up in a wide variety of situations. Pluralists, for example, have long argued that governing is a complex task that inevitably involves groups and organizations embedded in society (Bevir 2010). A clear preference for a dispersal of authority often accompanies these assessments (Montpetit 2016). Early students of corporate governance were motivated not just to describe authority relations, but also to suggest ways of ensuring that predatory managers did not exploit shareholders and stakeholders (Schleifer and Vishny 1997). For international development agencies, governance is not simply a matter of evaluating capacity; it suggests a set of criteria to be employed in determining who does and does not receive assistance and under what conditions.

Good governance implies conscious alterations in authority relations to achieve desired outcomes. Making these alterations and adjustments, however, requires action on the part of those who are currently part of the governance regime, either as the holders or the subjects of authority. Admonitions regarding good governance issue from consultants, international organizations, and academics, but changes in governance arrangements must come from those who are subject to them. In conceptual terms, governance arrangements are endogenously determined along with the power and authority relationships inside a system.

It is true, of course, that the era in which governance arrangements could be imposed from without is not completely over. In the mid-2000s the World Bank and several donor countries shifted their development strategy from the inducement of good governance via financial aid to the requirement of good governance as a precondition of aid (Nanda 2006). But where imperial or colonial governments could at one time insist on who would have authority and how it would be exercised, this strategy is now unsustainable, in part because the products of imposition have been deeply disappointing and in some cases disastrous (Scott 1998). Today the adoption of governance arrangements, and subsequent changes to them, are typically negotiated, albeit by those who have very different power resources (Moe 2015). Power is always a variable, so while it is quite common for governance and administration advocates to speak of "best practices," what is "good" in good governance is a matter of interpretation by those who are embedded in the system.

This realist perspective, which permeates our entire discussion of governance, does not mean that good governance is simply a matter of what is good for me. Ideas about how the world works and how it should work cannot be categorically dismissed simply because they do not accord with the short-term interests of those in power. Those who are not in power are listening, observing and experiencing the results of the current distribution of authority. So arguments for good governance practices must resonate with a variety of audiences, all of whom want to be persuaded that their payoff is just, reasonable or at least tolerable.

To recap, governance arrangements, along with power and authority, are determined endogenously in a system. These governance arrangements must deal with issues of corruption and ignorance in a manner that both allows the pie to grow (the economics problem) and allows for the pie to be distributed in a manner that is acceptable to participants (the politics problem). The purpose of the next two sections of the paper is to develop these ideas more fully.

In the next section we provide a definition of governance that makes good governance an empirical rather than definitional matter. Armed with this definition, we examine how power and governance arrangements co-develop. In the subsequent section we explore how corruption and ignorance affect the two underlying political economy problems of wealth generation and wealth distribution. We show, as other authors have done, how corruption generates outcomes that fail to grow the pie, while at the same time generating distributional outcomes that are highly disadvantageous. We then show how ignorance can have one of two effects, depending on the context. In the one case, ignorance—through its impact on transaction costs—can result in a failure of the pie to grow, often with detrimental distributional impacts. In the other case, ignorance can lead to increases in the size of the pie, albeit at the cost of redistributing the benefits of this growth to a particular group to such an extent that political instability ensues.

A Political Economy Model of Good Governance

The starting point for a political economy of good governance is that governance—the distribution of authority in societies and organizations—can only be understood as the product of both political and economic variables. Debates about what constitutes and creates good governance are rather empty without some indication of what governance is seeking to achieve. From a political economic point of view what we seek to achieve are governance arrangements that meet basic needs or, as Brian Barry (2005) puts it, "vital interests." There are many interpretations of what vital interests need to be met and the list can grow quite long. To shorten it, consider again the purpose of economics—the creation and distribution of wealth—and the purpose of politics—the orderly resolution of conflict. These are the core criteria that set the terms of debate for a political economy approach to good governance. Many positive values and norms are corollaries, including accountability, efficiency, and impartiality.

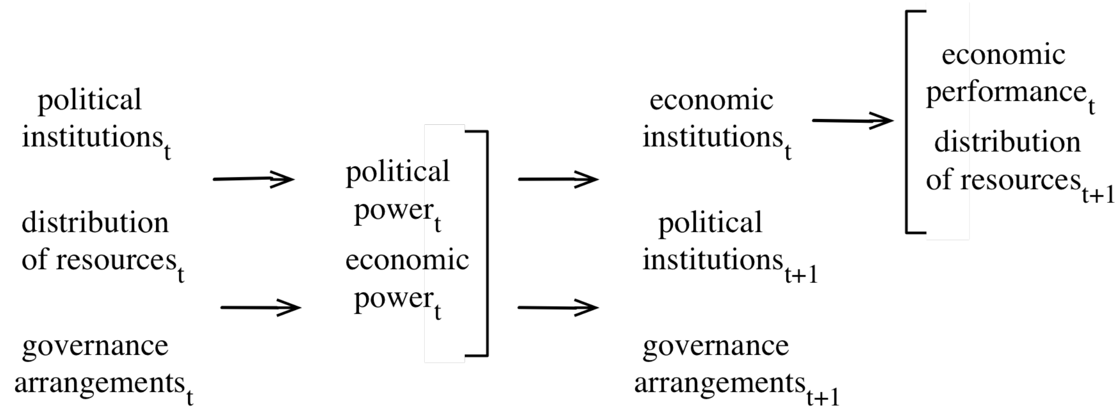
There is a danger in conceptualizing good governance as whatever produces, for example, economic growth or a particular distribution of wealth. As Rothstein (2011, 2013) points out, this kind of functionalist definition creates a tautology. One way of avoiding this tautology is to define what is "good" about good governance in terms of justice, equity or some other transcendent value. In Rothstein's case, good governance arrangements are those that adhere to the norm of impartiality; others argue for "universality" or similar criteria. This is an unobjectionable approach to definitional matters, but it bears emphasizing that government arrangements that meet criteria of procedural justice but fail to deliver the political-economic outcomes discussed above are unlikely to survive. Graham Wilson (2008) puts the argument this way: "In the real world … the apparently plausible goal of making policy only according to pre-specified criteria and rules is not only impossible but likely to result in poor governance." Procedures are important, but so are results.

Our approach is to define governance in terms of arrangements and procedures—institutions, norms, rules and roles—and make good governance an empirical rather than a definitional matter. Thus we define governance as *the set of formal and informal arrangements by which power is allocated and exercised in any system with interdependent actors* (e.g., a nation state, network, or organization). If these arrangements are good, they are able to create wealth and ensure it is distributed in an amount and a manner acceptable to society.

In our framework, we adopt North's view (1991, 1993) that institutions constitute the rules of the game of the political and economic system, while organizations—be they public, private, co-operative, non-profit— are the principal players in the game. Institutions—the rules of the game—determine how power and authority are distributed and the manner in which information is gathered, interpreted and used in decision-making. Governance is the expression of this power and authority.

Governance affects the creation and distribution of wealth through policy. Policy is the substantive expression of decisions taken by government—e.g., the taxes that are imposed, the programs that are launched, and the regulations that are set. Policy deals directly with the activities undertaken by the state (e.g., the provision of public services), or it can seek to affect the manner in which organizations (e.g., for-profits, non-profits, NGOs, co-operatives) or individuals behave. Regardless of the path, policy choices affect economic performance and the manner in which economic benefits are distributed among the various economic actors.

Policy can be expected to vary considerably across different governance structures, as well as within similar governance structures at different points in time. Policy differences occur because different institutions affect the nature of the governance systems in place, and hence the way that power is allocated and exercised. This allocation and exercise of power affects decision-making throughout the policy cycle—i.e., at the agenda setting stage, at the policy selection stage, and at the policy implementation stage.



Source: Acemoglu and Robinson (2006)

Figure 1 The Political Economy of Governance Arrangements

Figure 1, which is adapted from Acemoglu and Robinson (2006), outlines the endogeneity of governance structures and political and economic power, as well as the manner in which governance affects economic performance and the distribution of resources through policy. Governance arrangements in period *t*, along with the political institutions and the resource distribution in period *t*, determine the distribution of political and economic power in that period. The distribution of power, in turn, establishes the economic institutions in period t, as well as the political institutions and governance arrangements in period *t* +1. Through policy choices, the economic institutions in period t define the economic performance in period t and the distribution of resources in period *t* +1. With the political institutions, the distribution of resources and the governance arrangements in period *t* +1 determined, the process begins again.

While the objective of good governance is to generate economic performance and resource distribution outcomes that are acceptable to society, there is no guarantee that the governance arrangements generated by the feedback loops outlined in Figure 1 will produce these results. A key reason is power. If the “good” outcomes are detrimental to people with power, then these people will not choose governance structures that generate these outcomes. Mungiu-Pippidi (2015, 11) makes this argument using the metaphor that "good governance is like building a barn: it just needs a plan and some builders. The concept that some people with considerable power may oppose the construction of the barn as they benefit from its absence is seldom discussed."

The power of influential groups to block projects that are beneficial to others but not themselves, whether it is investments or the introduction of different governance regimes, has long been an issue of discussion in the political economy and policy literature (Robinson 1998; Acemoglu 2003). As we will see in the next section, this problem also needs to be considered alongside a different, albeit related, issue, namely how is it possible for those with power in governance arrangements to select outcomes that, while beneficial to them, are detrimental to other groups in society.

The Economics and Politics of Governance

To examine the two questions posed above, we develop a theoretical framework that models the way in which governance structures affect the policies that are chosen and the resulting distribution of power and payoffs. To capture these features, a number of assumptions and simplifications are required. We start with outlining these elements.

Consider a country with two groups, X and Y. This country has available to it, at least in principle, a variety of "technologies" that can be implemented—these technologies could be physical infrastructure such as railroads, or they could represent ways of doing things, such as the implementation of particular policies or the manner in which activities are organized. Each of the technologies results in the creation of a certain level of wealth and the distribution of this wealth between the two groups.

For each technology, the distribution of the generated wealth between X and Y can be illustrated as a point in Figure 2. Suppose, for instance, that the payoffs to X and Y for the current technology are given by point "a." Points located above and to the right of the 45° line passing through "a" represent payoffs from technologies that would enlarge the pie; points below and to the left of the 45° line represent payoffs from technologies that shrink the pie.

Governance arrangements reflect the allocation of power and authority held by different groups. This allocation is determined in part by the larger institutional environment in which the groups operate (e.g., well-defined property rights; democratic institutions), since this environment determines de jure power. The relative resources available to groups also determine power and authority; a failure to maintain these resources means a loss of power.

The relative resources available to groups are determined by the relative payoffs that are generated from the decisions that are made. Acemoglu and Robinson (2013) argue that the creation of rents provides the incentive to create organizations to capture these rents (for a similar point, see Robinson 1998). Thus, the greater are the rents that are created for one group relative to another, the greater is the incentive for this group to organize and the greater power it can then be expected to obtain. These observations suggest that the distribution of the benefits from new technologies matters to the groups, not just because of the returns *per se* that are generated, but also because of the power that these rents will generate in the future.

Also important in the political economy of the society is the extent to which a group can be deprived of economic benefits before they rebel in a politically destabilizing manner. Depending on the country and the context, this rebellion might take the form of active revolt (such as was the case with the Arab Spring), of seeking political separation (such as was the case in the U.S. Civil War), or of electing non-

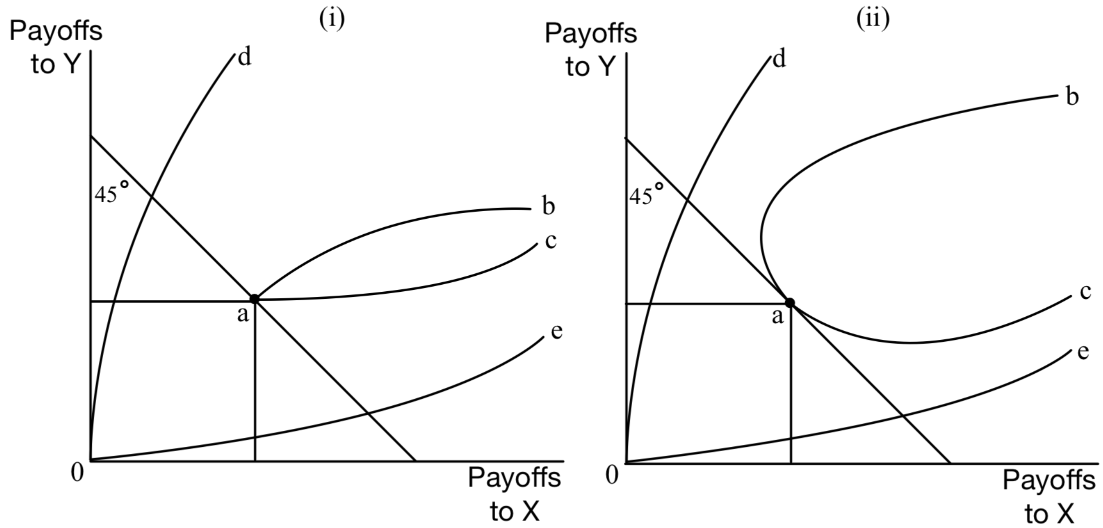


Figure 2 Payoffs and Power

mainstream politicians (as has been the case in the United States and a number of European countries).

These ideas are captured in Figure 2. Let's examine first the possibility of rebellion. The line *0d* shows the various combinations of payoffs to X and Y that would make X indifferent between rebelling and not rebelling, while the line *0e* shows the various combinations of payoffs to X and Y that would make Y indifferent between rebelling and not rebelling. The area between these two lines thus represents the set of payoffs for which the political structure is stable.

Now consider the question of maintaining power. The area between lines *ab* and *ac* represents the payoff combinations that, if chosen, would result in no change in the power held by the two groups. Points above the line *ab* would lead to an increase in power for Y (and hence a loss of power for X), while points below *ac* would lead to an increase in power for X (and a loss of power for Y).

The position and shape of the lines *ab* and *ac* in Figure 2 depend on the power the two groups possess at "a," as well as general features of the economic and political environment in the country under consideration. Panel (i) shows a situation where, at “a,” X has relatively more power than does Y; this case also assumes that the relative power of X and Y is largely determined by the resources/payoffs to which they have access; de jure sources of power are relatively small.

In contrast, panel (ii) shows a situation where the power held by X and Y at “a” is much more equal. In addition, a good deal of the power each group possesses is de jure in nature and is not as heavily determined by resources. For instance, panel (ii) might reflect a country with strong democratic institutions, one in which access to economic resources has only a small effect on the likelihood of electoral success for either X or Y. In such a world, either X and Y could, from time to time, introduce technologies that would result in losses to the other group and yet not alter relative power. Such moves are possible as long as there is an expectation that at some point in the future the group that previously suffered a loss would be able to introduce a technology that would benefit it while imposing a loss on the first group.

The framework presented in Figure 2 can be used to show how governance arrangements, the distribution of power, and economic benefits are jointly determined and evolve over time. Two cases will be considered—corruption and ignorance—each corresponding to one of the two chronic conditions outlined earlier in the paper.

Corruption

In our examination of corruption we consider two different informal arrangements for the exercise of power. In the first arrangement, people follow formal rules that are defined by the office they occupy; monitoring mechanisms and penalties provide support for these rules. In the second arrangement, people make decisions based on personal advancement.

Point “a” in Figure 3 captures the distribution of benefits that emerge from the second of these governance arrangements; it can be characterized as a high

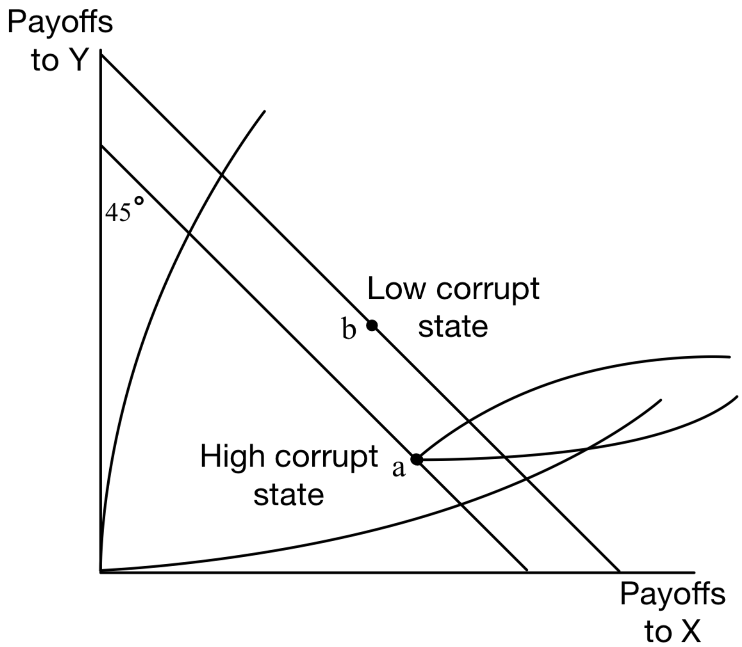


Figure 3 Corruption and Governance

corruption outcome. Point "b" captures the distribution of benefits that emerge from the first governance arrangement; it can be viewed as a low corruption state. The low corruption state creates more wealth (as Mauro (1995) shows, corruption is associated with lower economic growth rates), with a somewhat more even distribution of the benefits between X and Y.

Binmore (2003) argues that either outcome "a" or "b" could emerge as an equilibrium depending on the set of expectations that are in place. Following - Pippidi (2006) and Persson et al. (2012), corrupt behavior can be understood as being the appropriate strategy for individuals in countries where the expectation is that corruption is rife. As Persson et al. (2012, 450) indicate, "insofar as corruption is the expected behavior in a particular society, we should expect the key instruments to curb corruption in line with the principal-agent anticorruption framework—that is, monitoring devices and punishment regimes—to be largely ineffective since there will simply be no actors that have an incentive to enforce them." Thus, although other governance mechanisms, such as office-defined rules, could support lower levels of corruption, there is no incentive for players individually to change their behaviour. Instead, what is needed to move from "a" to "b" is a new set of expectations that everyone adopts.

In addition to "a" being an equilibrium from which escape is only possible if all parties adopt a new set of common expectations, "a" has the property that it provides greater benefits and more power to X than does "b." As illustrated in Figure 3, a move from "a" to "b" would involve moving outside the lens in which political power is held constant and moving to a point where the power of X would decrease. Since such a move makes X worse off in terms of both payoffs and power, X would not be expected to support the development of governance structures associated with "b."

It can also be noted that if "a" is pushed too far down and to the left, it may lie under the line where rebellion on the part of Y becomes a possibility. In this case, corruption is not a stable outcome. Further discussion of non-stable cases is provided in a later section.

Taken together, the unwillingness of a dominant group to change the rules and the difficulty of getting a new set of expectations adopted by everyone make escape from positions like "b" very difficult (although not impossible, as Manion 2003 shows). As has been stressed, position "a" embodies a combination of a particular governance structure, a particular power arrangement, a particular level of wealth and a particular distribution of this wealth. Efforts to change one or two of these features, without addressing all the features, is almost certain to be unsuccessful.

Ignorance

In addition to corruption, the other chronic condition that leads to poor outcomes is ignorance. In this section we consider ignorance from two different perspectives: one where the combination of ignorance and concerns about power result in good technologies (i.e., ones that would lead to better outcomes for both groups) not

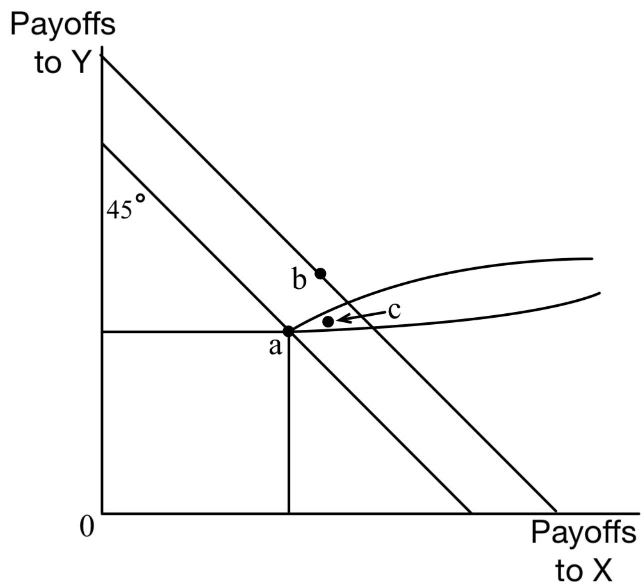


Figure 4 Power, Governance and Transaction Costs

being adopted and one where the combination of ignorance and power results in outcomes that can threaten political stability. The first perspective will be examined under the heading of transaction costs, while the second perspective will be examined under the heading of failure to foresee conflict.

Transaction Costs

Figure 4 illustrates the case where the combination of ignorance and concerns about power result in good technologies not being adopted. Suppose a country is currently located at point “a” and that a new technology could be introduced that would move the economy to “b.” Suppose also that the governance structure in place reflects the fact that X has more power than Y. As can be seen from Figure 4, the technology that generates point “b” is not likely to be acceptable to X. The reason is that point “b” lies above the lens in which relative power remains constant; thus, if “b” were to be chosen, X can be expected to lose power and with it the ability to generate benefits in the future. Thus, to the extent that X has the ability to block the introduction of the new technology, it would do so. Note, however, that blocking this technology means that the country fails to expand its economy—in economic terms, the size of the pie is not increased.

In the strict economic sphere, the Coase theorem provides a solution to such problems (Coase 1960). This solution requires Y to compensate X so that X benefits sufficiently to agree to the introduction of the technology. For instance, a deal that moves the two groups to point "c" would allow both X and Y to benefit. The Coase outcome, however, can fall apart due to transaction costs. Transaction costs are the costs of specifying, monitoring, carrying out, and enforcing a transaction (see Dixit 1996) for an excellent discussion). As Coase (1960) argues, if these costs are sufficiently high, they can exhaust the benefits obtained from the new technology and it will not be chosen. This outcome can be illustrated in Figure 4 by noting that if transaction costs are present, point "c" does not lie on the 45° line running through "b," but instead lies below this line. If the transaction costs are high enough, "c" would be located below the 45° line running through "a," and both X and Y would prefer the original technology.

Another reason for the failure of the Coase outcome is that the bargain that moves the outcome from "b" to "c" would have to involve a shift in power as well as payoffs in order for it to be acceptable to X. As outlined above, point "b" is associated with greater power for Y—indeed, it is this greater power for Y that causes X to reject the technology. If the bargain between X and Y only involves a transfer of payoffs, then it may not address the key issue that caused X to reject the technology in the first place. Instead, what would be required is a transfer of payoffs in a way that also involves a transfer of power so that X is not disadvantaged in that regard. As Acemoglu (2003) and Acemoglu and Robinson (2001, 2013) discuss, such transfers typically involve the introduction of additional costs so that "c" lies below the 45° line running through "b," even in the absence of the transaction costs discussed above. From an economic perspective, the need to provide compensation in terms of power is, in effect, a transaction cost. Notice that attempts to remove the political element from the bargain between X and Y are likely to result in overall poorer performance for the economy, since doing so would result in the economy remaining at “a” instead of moving to “c.”

Ignorance plays a key role in determining the transaction costs discussed above. Transaction costs can take many forms, including problems in distributing the benefits efficiently, challenges in seeing and organizing the arrangements needed to allow a bargain to be reached, and as outlined above, difficulties in making credible commitments (i.e., ensuring that X’s power is preserved). Without active solutions to these problems—i.e., without good policies—agreements are difficult to reach and the status quo remains entrenched.

Consider, for instance, the difficulties that exist in identifying the opportunities for mutual gain, in providing assurance of benefits, and in finding novel ways to make the transfers that are necessary to achieve agreement. Those who stand to lose from a policy change are likely to resist it unless there is substantial compensation (this problem is exacerbated because of loss aversion (Flyvberg 2009). At the same time, those who stand to gain will be reluctant to pay the costs of compensation themselves since gains are often uncertain (Trebilcock 2014). The more these difficulties can be reduced, the greater is the likelihood that “c” would be selected. In addition, it is necessary to find ways to address the political problem of providing X with the assurance that its power will not be diminished. Dealing with these issues means dealing with the ignorance problem, since it is only by truly understanding the nature of the problem and finding creative ways to address it that a solution can be found.

The presence of transaction costs means that, as was the case for corruption, governance arrangements, power structures and economic outcomes are jointly determined. The choice of technology, which is determined by the governance structure, affects the benefits that are available as well as the power that groups possess. Or, as Coase (1960) argued, when transaction cost are present, decisions about the size of the pie cannot be separated from decisions about the distribution of the pie. The conclusion from the above analysis is that political considerations mean that transaction costs will almost always exist, which means that the separation of the purely economic question (the size of the pie) from the political question (conflict over its distribution) cannot occur. Ignorance becomes a key factor when this linkage is not recognized and/or when attempts to address this linkage are not given sufficient emphasis.

A number of authors have argued that democratic regimes produce better outcomes because a more cognitively diverse set of decision makers typically provides greater epistemic capacity than a better qualified but smaller, less diverse elite. A diversity of experience, identity and modes of reasoning all contribute to better collective outcomes (Page 2007; Hong and Page 2012), but what is really important is cognitive diversity, the different models that people employ in interpreting how the world works or should be understood (Landemore 2013, 160).

While the epistemic capacity of democracies is advantageous in terms of lowering transaction costs, democracies offer another advantage—they enlarge the set of outcomes that are acceptable to both X and Y, making it easier for both groups to support new technologies that have differential benefits. The notion that well-functioning democracies can enlarge the set of acceptable outcomes is seen by comparing panel (i) and (ii) in Figure 3. The enlargement of the acceptable outcome space occurs because more of the political work (i.e., dealing with conflict) can be done outside of the economic sphere, thereby opening greater opportunities to enlarge the pie.

Taken together, these two advantages significantly increase the likelihood that democratic regimes can operate in a manner that both enlarges the pie and allows for its distribution in a manner that is less fraught with conflict. As we will see in the next section, regimes that are less that fully democratic may also be successful at enlarging the pie; however, to do so may come at the cost of creating more conflict. It is to this question that we now turn.

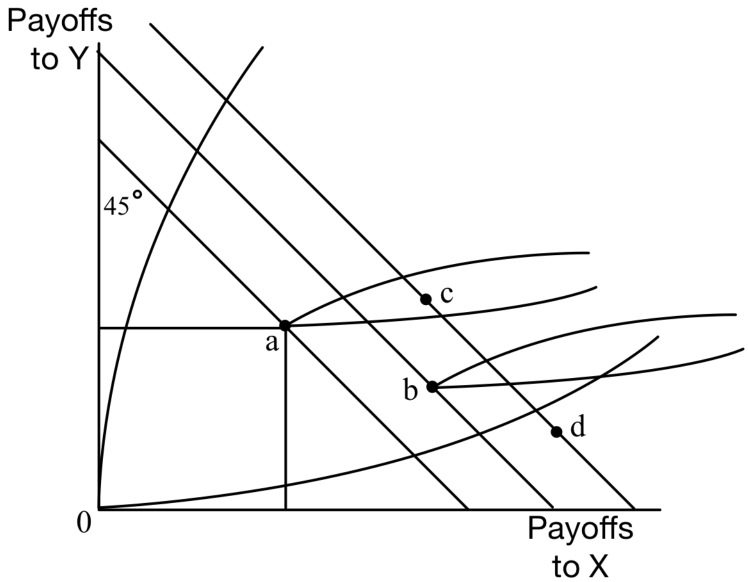


Figure 5 Power, Governance and the Failure to Foresee Conflict

Failure to Foresee Conflict

Figure 5 illustrates the case where, contrary to the situation modeled in Figure 4, the power balance in a country does not prevent the adoption of a new technology that would enlarge the pie. As in the previous case, the country starts with the payoffs given by point “a.” The introduction of the new technology would result in payoffs given by “b.” If X has the power to approve the introduction of the technology, then it would be expected that it would do so—point “b” provides higher payoffs and more power than does “a.”

This “solution” to maximizing the size of the pie—namely providing power and authority to those who benefit from the technology—was noted by both Coase (1960) and Robinson (1998). While the problem of maximizing the size of the pie is addressed, it is possible that doing so could result in significant conflict. Indeed, the conflict could be such that it would lead to rebellion by Y.

A move to "b" increases both the power and the payoffs for X, and decreases the power and payoffs for Y. Although Y is worse off, it would nevertheless accept the move from "a" to "b," since "b" is located within the region that denotes political stability. It useful at this point to examine why Y would accept a move that makes it worse off.

One of the answers to this question was examined earlier in our discussion of corruption. Since governance arrangements can be thought of as equilibria, then it follows that all the parties subject to this arrangement will have an incentive to comply with the arrangement and the decisions that arise from it. Note that this incentive to comply exists at the individual level. While it might be possible for the individuals in Y to act collectively in a different way and achieve a different outcome, individually each member of Y is best off abiding by the governance arrangement in place.

Another reason rebellion is not chosen is that it is costly (Acemoglu and Robinson 2006). Even if the free rider problems could be solved and the members of Y could act collectively, rebellion is only chosen if the expected benefits of rebellion (which are determined by the probability of success of the rebellion and the gains that can be expected if successful) are greater than the costs. Since the costs are often significant, rebellion is often not a preferred option.

A further reason for compliance is the nature of governance arrangements. Recall our governance definition—governance is *the set of formal and informal arrangements by which power is allocated and exercised in any system with interdependent actors*. Culturally, formal and informal arrangements are more than just the specification of how things are organized. Instead, formal and informal arrangements typically take on a value in their own right.

The source of this value is a norm psychology (Henrich 2015). This psychology, which is the outcome of evolution over millions of years, means that people intuitively assume the social world is rule governed, even if the rules are not known, and that violation of these rules is likely to have negative consequences. As a result of their belief in the existence of rules, people infer that the behavior of others is affected by these rules. As people learn these norms and rules, these norms and rules are at least partially internalized so that they become goals to be achieved.

This psychological behavior means that once a governance arrangement is established, abiding by it becomes an objective in itself. As a result, governance arrangements can be sustained for long periods of time, even when they routinely generate outcomes that are detrimental to particular individuals and groups. In short, the value of maintaining the rule offsets the cost associated with doing so.

Henrich (2015) points out that the people most effective at establishing norms and rules that others will follow are those that possess either dominance or prestige. Dominance typically relies on threats and coercion for influence and is marked by aggressive and egocentric behavior. Prestige, in contrast, typically involves persuasion and deferential agreement, and is marked by generous and cooperative behavior. What is interesting about prestige is it emerges from what is deemed to be important and valuable in a specific domain—thus, hockey stars, rock musicians and great thinkers can all enjoy prestige. As Henrich (2015, 139) notes, "While not infinitely malleable, what constitutes a *valued domain* is amazingly flexible. The differential success of societies and institutions will hinge, in part, on what domains are valued."

If we apply Henrich's observation to governance, we would conclude that different governance arrangements could emerge simply as a result of who enjoyed prestige or dominance in a particular situation. These prestigious or dominant individuals would establish norms and rules that others would not just mimic, but would ultimately adopt as goals to be achieved. Thus, different societies can be expected to develop not just different norms, but to develop norms that emphasize and reward different things. The consequence is that different societies can be expected to follow different paths; some of these paths will involve significant disparities in payoffs and power.

The presence of a governance equilibrium, the problems of collective action, the costs of rebellion and the psychological value attached to norms all provide reasons why the distribution of power and authority can be quite skewed in X's favor and yet not result in rebellion by Y. At some point, however, it is expected that the payoff and power distribution will be so skewed that rebellion becomes a possibility. The lines $0d$ and $0e$ in Figure 2 show the locus of payoffs at which rebellion occurs.

The possibility of rebellion becomes important when the situation portrayed in Figure 5 is examined dynamically. As noted above, the move from "a" to "b" results in more power and greater payoffs for X. It also creates a new status quo at "b." Point "b," of course, has associated with it an area—a lens—in which the power of X and Y do not change. The shift of this lens down and to the right means that it becomes unlikely that technologies that generate outcomes like "c" would now be acceptable to X, even though they would have been acceptable when the starting point was "a." Instead, the technologies that are acceptable to X are ones that generate outcomes like "d."

Payoffs like "d," of course, result in a further skewing of power and payoffs in favor of X. In Figure 5, "d" is located below the political stability line, indicating Y is now sufficiently disadvantaged that rebellion becomes an option. The potential for a major disruption of the political equilibrium now exists, even as the economy is growing.

This outcome requires that X does not anticipate the political upheaval that would result from moving to "d." Is this reasonable? Would X not rationally understand the problems that would occur by crossing the political stability line and refuse to accept a technology that produces these results?

There are a number of reasons to expect X would not be rational in this sense. One reason is that X may have a relatively short time horizon and thus be impatient to obtain the payoffs and power associated with "d." If this impatience is large enough, the possibility of rebellion could be discounted sufficiently to allow "d" to be chosen.

A second reason is a collective action problem. Although the members of X may hold considerable power through the governance structures that are in place, no individual member of X sees all the situations where moves are being made to points like "d." As a result, each individual fails to see the full extent of the problem until it occurs.

A third reason is that situations like the one described in Figure 5 typically do not occur very often. Indeed, given the political stability that has been assumed prior to the point in time when the crossover occurs, there would have been no experience with rebellion and only a vague sense of where the boundary line lies. The problem here can be characterized as one of uncertainty—there is simply no solid basis on which to make inferences about will happen in the future.

A fourth reason is also linked to ignorance. Even if the signals are present that a society is getting close to the political instability line, they may be incorrectly interpreted because of cognitive biases—examples include the availability bias, the representative bias, the confirmation bias and the self-interest bias.

One obvious solution to all four problems, and particularly the last two, is greater epistemic capacity for the members of X. The collection and analysis of data on the extent of the unequal distribution of power and payoffs, a better understanding of the effects of an unequal distribution, and comparisons from other countries would all aid in being able to identify the problems that can arise from unequal distribution.

Interestingly, if this increased epistemic capacity filters over to the members of Y, the result may be a movement inwards of the rebellion line, making it more likely that political instability occurs as power and payoffs are concentrated in the hands of a particular group. If the members of X have an intuitive understanding of this dynamic, they may underinvest in epistemic capacity.

As was argued earlier, the development of widespread epistemic capacity may be one of the hallmarks of democratic systems. Thus, the more democratic is a system, the more it can be expected that wide variations in power and payoffs will be unacceptable. However, it does not then follow that democratic systems should be less politically stable. The reason is found in the analysis of the previous section, where it was argued that more democratic systems can be expected to have larger areas—larger lenses— in which technologies can be introduced without fundamentally changing the underlying power structure. In other words, the more democratic is a system, the less likely it is that it will veer off into the unstable territory (see Przeworski et al. (1996) for support on this point).

To recap, while the presence of a governance structure that allocates significant power to one group does not preclude economic growth and an enlargement of the size of the pie, the growth that does occur can be expected to maintain or enhance the power imbalance. One of the concerns to emerge from a continued power and payoff imbalance is political instability. Thus, as in the other cases that were examined, governance structures, power relationships, and economic and political outcomes are jointly determined.

Conclusion

In recent years there has been a marked increase in interest in what constitutes good government, good governance and quality of government. In addition to a broad consensus that government is no longer the key player in governing the economy, a concern has emerged that pursuing economic growth alone will not generate the best outcomes for society.

These ideas are linked. The initial response to the recognition that government could not unilaterally direct the economy was to include a host of other players, including the private sector and NGOs, in governance. In the case of developing countries, one of the concerns of this approach was readily understood—would these players have the incentive to encourage government to introduce policies that would promote growth? The efforts of the World Bank to encourage specific forms of governance were an attempt to address this problem. While the initial emphasis was on specific fiscal and monetary policy in the context of structural adjustment policies, attention has now shifted to an emphasis on creating the capacity for good decision-making (e.g., reductions in corruption). In both cases, the overarching concern was whether those with power and authority would introduce policies beneficial to the larger society.

What was much less understood initially was a separate problem—would those with power and influence introduce policies that encourage growth, albeit at the expense of social inclusion? As the OECD now recognizes, this problem is of real concern. This is particularly the case for developed countries where rising inequality and lack of inclusiveness threatens political stability and economic activity, although developing countries such as China have not been immune to the problem.

The analysis in this paper shows that both of these problems emerge from the nature of governance, and are exacerbated by two chronic conditions associated with governance, namely corruption and ignorance. More specifically, the paper argues that governance arrangements reflect both economic and political forces, and are jointly determined along with the distribution of power and the creation and distribution of economic payoffs. As a result of this joint determination, governance cannot be imposed on systems; nor should it be assumed that economic and political systems left on their own will evolve in ways desirable for everyone.

As a consequence, we should be wary of attempts to introduce best practices; unless these practices happen to fit with the prevailing political economy, they are unlikely to be successful. At the same time we should be wary of simply leaving governance systems to evolve on their own, since there is considerable reason to believe that they may not develop in ways that are deemed to be good.

Given these observations, is there anything that can be done to move systems in ways that are desirable. The one conclusion that can be tentatively drawn is that democratic systems may be better at generating inclusive growth (to use the OECD's language) than non-democratic systems. As we have seen, it is extremely difficult, if not impossible, to impose democracy on inherently non-democratic systems; the result is that the problems facing most developing countries are very challenging to address and have to be approached with great care.

What about in democratic societies? Here it may be possible to take steps to ensure that democratic societies remain democratic. Of key importance is epistemic capacity, since its maintenance and improvement appear to be connected with the ability for a society to choose technologies that enlarge the size of the pie while ensuring a relatively constant level of power and payoff inequality.

On this issue, one of the key problems facing a democratic society is a collective action problem. Since epistemic capacity is created and maintained through the actions of everyone—the education people receive, the degree to which people rely on evidence, the ability of people to experiment—and since these actions are often personally costly, the tendency is for the people to underinvest in such activities. Tackling this tendency requires large-scale co-operation, co-operation that can likely only be sustained through the development of widely accepted norms such as universalism (Mungiu-Pippidi 2006, 2015), and experimentation and consequentialism (Knight and Johnson 2007, 2011). Just as norms are the culprit behind corruption and the acceptance of widespread disparities in power and payoffs, so too are norms the means of overcoming these problems. As we have seen in this paper, norms play a key role in the co-determination of governance systems, the distribution of power, and the growth and allocation of the economic pie. As a result it is not surprising that they should be key factors in the development and maintenance of good governance.

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