Special Article

Governance Institutions & India's Development

Avinash Dixit

By economic governance is meant the structure and functioning of those legal and social institutions that are essential for economic activity and economic transactions to flourish. They consist of protection of property rights, enforcement of contracts, and a variety of collective actions for provision of infrastructure and include not just the physical infrastructure of transport, communication etc. but also the organizational infrastructure by which property rights and contracts are managed. Collective action is taken by the government for provision of public goods. But collective action for economic governance is also taken via many other organizations or institutions, such as NGO's, community organizations of various kinds, and informal institutions of social networks and social norms, argues the paper.

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Economic Governance

Economic governance is a buzzword that has arisen just over the last 30 or so years. EconLit which is among the primary sources of citations of academic articles in economics shows that before 1979, there were only five mentions of the word governance in all of economics academic literature. By the end of last year, the cumulative total has grown to more than 33,000.

The trouble with buzzwords is that everyone interprets them in his or her own way. That is unavoidable; therefore I will give you my definition and leave it at that. If other people have somewhat different definitions, that is fine also.

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Why is this important? We all know the reason, but a quick restatement is useful. Security of property rights is essential if people are to accumulate property. If they were not confident that their property would stay in their ownership, if they feared that somebody would rob it, they just would not create or acquire it. Next, it is essential for efficient allocation of assets. You may have accumulated savings, but their most productive use in the economy might be with somebody else. If you give it over to them to manage and they can run away with it, the fear of this prospect will stop you from ever giving it to the most efficient user in the first place.

Good protection of property enhances the productivity of labour.

Perhaps even more interestingly, and this may be especially important in the context of India, good protection of property enhances the productivity of labour. If your property in the form of capital, land, house etc. is not secure, you will have spent a lot for your own labour time and effort to try and guard your property. If your property rights are secure, that labour time will be freed up for actually performing productive work. Erica Field, an Assistant Professor at Harvard, in her Princeton Ph.D. thesis showed this to be the case in Peru (Erica Field 2006). I am sure that if a similar study was done in India, it would come up with similar results.

Enforcement of contracts is important for similar reasons. Efficient conduct of an economic transaction may require you to perform an action for the other party, and the other party will pay you or perform something else for you later. If the contract cannot be enforced, you are not secure in the knowledge that the payment will actually be made as stipulated. Then you will never step into that transaction in the first place, and the potential mutual gains will not materialize.

Something else that is not all that often thought of in the context of governance is collective action. Various kinds of collective action are necessary for provision of public goods, for example management of common resources of the environment and other common property. These issues are prisoner's dilemmas. Provision of public goods requires everyone to contribute, but everyone has the temptation to free ride hoping that the others will provide it. But as my teacher Charles Kindleberger used to say, if everybody free rides, then the bus will never get out of the station in the first place.

Collective action is sometimes taken by the government. In fact, theoretically that is why governments are formed. But collective action for economic governance is also taken via many other organizations or institutions, such as NGO's, community organizations of various kinds, and informal institutions of social networks and social norms.

Finally, collective action is important for imposing checks and balances on governments, to stop them from arbitrary exercise of power, and stop them from extorting from the people whom they should be serving. This is especially important in many less developed countries, and in many transition economies.

Some Conceptual Distinctions

To discuss and apply the concepts of governance in more detail, I need to make three kinds of distinctions.

The first distinction is between what I call economic governance and what is commonly called 'corporate governance'. Economic governance is for transactions between different legal economic entities, particularly different firms, and enforcement of contracts between different firms, for example between buyers and sellers.

Corporate governance is about activities within a firm: conduct of the agency relationships that exist between shareholders and managers, between top-level management and middle level management etc. Of course, the two are linked, because of the famous proposition of Coase and by Oliver Williamson that the boundary of a firm depends on the relative transaction costs of using markets and using internal organization in a firm. And transaction costs include governance costs.

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If economic governance in my sense of governance of contractual relationships between different firms is of low quality, more activities will be kept inside one firm. Firms will be larger and will use internal transactions, implicit contracts etc. Family conglomerates in many less-developed countries are prime examples of this. We find them in India, and also in countries like Turkey. When you look at the activities that a conglomerate like Sabanci or Tata covers, you start to wonder why they are all within one firm. There does not appear to be any kind of direct synergy or connection between these different activities – either vertical or horizontal in the economic sense. There may be other explanations, but an important aspect is that these conglomerates are really internal capital markets. If one division of Sabanci has high profit, they could in principle lend it out to the market in general at the best rate that they could get. But if this high return is not secure because contracts with others cannot be securely enforced, then it would be better to keep it within the family where the relational set up will ensure repayment.

Corporate governance and internal relations can to some extent substitute for lack of economic governance but cannot do a perfect job.

This has a benefit in that it allows some transactions to take place that would never have taken place otherwise. But it also has a cost because the most productive use of capital in that economy may not be another division of the Sabanci empire but somewhere else. Capital markets are compartmentalized and cannot be as efficient as they would be with better economic governance of contracts across firms. Thus corporate governance and internal relations can to some extent substitute for lack of economic governance but cannot do a perfect job.

The second distinction is between governance and government: governance is not always supplied by the government. In fact this theme has been an emphasis of my own recent research. Normally people do confuse the two. If you look at the World Bank's governance website, 90% of it has to do with governments and corruption, and very little deals with other kind of institutions of governance. Governments are important, particularly for protection of property rights. If governments are not doing a good job of protecting property rights, that can be a major cause of poor economic performance. Again, this can be a problem especially in less developed countries and in transition economies.

But I want to emphasize and hope to demonstrate the talk that other social institutions of governance also exist. Sometimes such institutions do things that governments are not able to do or refuse to do. At other times and in other situations, they have advantages over the government's formal mechanism, in terms of information, or even in the kinds of sanctions that can be imposed on violators of property rights and contracts.

Government or its agents themselves often violate people's property rights and contracts.

And of course, there is the problem that the government or its agents themselves often violate people's property rights and contracts. They extort bribes from the citizens, they make arbitrary changes in laws and regulations, suddenly raise the tax rate, suddenly impose constraints on repatriation of profits, and so on. Other social institutions must play an essential role to prevent the government from such actions.

Related to this, the third distinction is between de jure and de facto: the law on the books is often not the same as what actually happens. We have a phrase 'law and order' as if the two were the same thing. They are not. You need to distinguish between them. This may be especially important in India where the formal law in the statutes is very good, but the way it actually functions in reality often leaves a lot to be desired.

I will give an example of this from a completely different situation. The typical problem of contract enforcement is a prisoners' dilemma, where everyone has the temptation to cheat, and real conflicts arise. But think of a much simpler situation, namely a pure coordination problem where if you knew that everybody else was doing the right thing, it would be in your own interest also to do the right thing. Thomas Schelling gives the best example of this, namely a traffic light at an intersection. Without any coordinating institution, drivers from the two sides do not know who gets to go first. But a traffic light (law) should achieve coordination (order): if it is green, you go; if it is red, you stop. That is the law on the books. What actually happens can be quite different. Some dramatic video clips on You Tube illustrate this [http://www.youtube.com/watch?v=H2JFL1Sk21Y]. An intersection in St. Petersburg, Russia illustrates traffic "law without order". There are traffic lights, but some people abide by them while others do not and speed through regardless. The result is frequent and serious accidents. Conversely, videos in Mumbai and Hanoi illustrate "order without law" [http://www.youtube.com/watch?v=5WU8hilbN9Y] and [http://www.youtube.com/watch?v=eC4BN9kInXg].

There are no traffic lights or policemen, but there are social norms of precedence, which combined with a little care and slower speeds enable accident-free flow of quite heavy traffic. A book published last year argued that in fact these kinds of social-norm-based traffic flow systems are generally superior to traffic lights (Tom Vanderbilt 2008). All I want to do is to point out the possibility of law on the books being completely irrelevant to how people actually behave, and sometimes vice versa.

Most economies have a mixture of formal law and social norm based institutions. Arbitration is an excellent example of other kinds of alternative dispute resolution (ADR) forums as they call them in America, which work with formal law in the background. Going to court is extremely costly in terms of money, time etc.; industry-based expert arbitrators can use their knowledge to interpret the situation much more quickly, cheaply, and accurately. Therefore very often recourse to the formal legal system is actually the last resort rather than the first one. Macaulay's famous article discussed this, and it has been corroborated in much subsequent legal research (Stewart Macaulay 1963)

Informal governance prevails in financial transactions, too. Alan Greenspan's autobiography has a lovely quote bearing on this: "in a free society governed by the rights and responsibilities of its citizens, the vast majority of transactions … presuppose trust in the words of … strangers. … Reputation and the trust it fosters [are] the core attributes of market capitalism." (Alan Greenspan 2007: 256). For example, brokerage transactions with your broker are almost always done by phone, with no written record, and they are usually honoured by both sides.

But social institutions also have their limit. They do not deliver perfect outcomes. Traffic accidents do happen in Vietnam, and also in India as I am sure that you know from your own experience. And events in financial markets over the last year have shown vividly that Greenspan's lovely vision of trust and reputation based transactions did not quite work. In the real world, we do need checks and balances, we do need regulation. Greenspan recognized this: "The most effective defence against fraud … is counterparties' surveillance. JPMorgan thoroughly scrutinizes the balance sheet of Merrill Lynch before it lends. It does not look to the SEC to verify Merrill's solvency." (Alan Greenspan 2007: 257). Wisdom on this point comes from an unexpected source, Ronald Reagan. He repeatedly quoted a supposed Russian proverb to Mikhail Gorbachev's annoyance: "Trust, but verify." (Доверяй, но проверяй.)

Debates on economic policy issues, especially in India, used to be cast in the form of markets verses planning. I want to argue that as far as governance is concerned, that is completely irrelevant.

In all economies, state institutions and private institutions of governance co-exist.

In all economies, state institutions and private institutions of governance co-exist. Many economic transactions do not take place in conventional markets at all but within firms, within families, within social networks. We have to examine the interaction of this whole system, and understand what works well and what works poorly, what combinations or mixtures of different types of systems will work in one situation. In general, a mixture will be optimal, but nothing will be the perfect or first-best ideal. Everything is going to be second best or third best or 19^{th} best or even worse.

Typologies of Governance Institutions

Formal state institutions start with the deepest ones like the constitution, which lays down the broad rules of the economic game, and go on to include the legislature, which gives specific content to these rules, and the whole apparatus of police, courts, licensing bodies, regulatory bodies etc. that enforce and implement the rules. Informal or private social institutions consist of networks, both for finding who the good contractual partners are, and then also for dealing with them, stipulating the norms of what is good behaviour in economic transactions, stipulating social sanctions against people who violate those norms, and a variety of private adjudication and enforcement mechanisms to implement these sanctions when needed.

The mechanisms of economic governance could be classified into three types; first-party, second-party and third-party. First-party mechanisms are those that try to instil value systems into traders so they internalize the norms of good behaviour in their economic dealings with others, and therefore refrain from cheating in the first place – not 100% of the time, not 100% of the people, but a sufficiently large proportion sufficiently often.

Second-party mechanisms involve detection of bad behaviour, and enforcement of the sanctions against bad behaviour, by either the victim of the cheating or by others in that social network that may have dealings with the cheater later. Second-party mechanisms depend on good information and communication channels in the social network, so others can find out who has cheated, and whether others have carried out their part in the stipulated punishment of cheaters. These information and communication channels become weaker when the network becomes larger. In a community of say 100 or 150 business-people, where everyone knows everyone, they are able to find out relatively easily and accurately who has behaved in conformity with the social norm and who has misbehaved, and are able to enforce the stipulated sanctions when necessary. If the community grows to say five or ten thousand, that starts to become harder to achieve (Avinash Dixit 2003a: 1293-1317, 2004: chapter 3).

Third-party mechanisms are ones operated by people or organizations that are not themselves direct participants in the trade but are providing substitutes for the government's legal system. Arbitration forums are an example; so is the mafia, which often enforces illegal or otherwise shady transactions that occur outside the state system. These types of alternative mechanisms have some advantages and some disadvantages. The main advantage of some of these institutions is that they include experts who are much better able to evaluate specialized information relevant to the dispute than the general courts. They know the customs and practices of the industry. They do not need a very detailed laid-down contract of which they have to interpret every word. They know the way things are done and they are able to see whether the things were done in the right way. If things were not done in the right way, they are very often able to inflict really severe penalties, basically cutting off the guilty trader from all future trading opportunities.

The doctrine of 'forbearance' which says that if a contract stipulates arbitration, a dispute arises, the stipulated forum renders its judgment, but the losing party refuses to obey that judgment, the court will merely enforce the judgment using the state's power, it will not rehear the whole case.

The courts know this and respect the findings of such expert arbitrators. In the U.S. there is the doctrine of 'forbearance' which says that if a contract stipulates arbitration, a dispute arises, the stipulated forum renders its judgment, but the losing party refuses to obey that judgment, the court will merely enforce the judgment using the state's power, it will not rehear the whole case. This is a good way to mix formal and informal governance, combining the informational advantage of the arbitration system and the enforcement power of the state. I do not know if very similar doctrine exists in India, but if it does not, then introducing it may be a useful reform.

A problem with third parties like the mafia is that their honesty is not automatic; they may collude with one of the traders to let him defraud another. If such governance is to work, there must be self-enforcing incentives for the third party to stay honest. In essence, what was a one-time interaction between two traders is converted into a repeated game of each of them with the third party. This was one of my main research topics in this area, because it was amenable to game theoretic solution in an interesting way. But I won't go into that because that's not really the main issue that I want to talk about here. (See Avinash Dixit 2003b: 449-481, 2004: chapter 4).

India's Strengths & Weaknesses

I can identify several strengths that India possesses for good economic governance. Probably the most important is the well-educated and well-interconnected community of people from government, business and academia, who are able to act as guardians of the system. This seminar is itself an excellent example of that. It would be very difficult to think of a seminar in America where large numbers of businesspersons and academics meet to discuss such issues at a really high conceptual level. The interactions between business and academia in America are usually at very low levels of clichés and nostrums.

There has been a steady progression of reforms. Even when the party in government changed, there was no wholesale reversal of reforms.

India's second strength is the broad continuity of reforms and policies over the last 20 years, despite many changes of governments. Being too close to the events you may think that policies have fluctuated a great deal. But if you stand back and look at what has been happening over the last two decades and more, you will see that broadly, there has been a steady progression of reforms. Even when the party in government changed, there was no wholesale reversal of reforms. The speed may have increased or decreased from time to time, but the direction on the whole stayed constant. The economic experts and civil servants who analyze and recommend policies often stayed the same while politicians changed, and this may have contributed to the continuity.

The freedom of media that exists in India is extremely important.

Third, the freedom of media that exists in India is extremely important. There are examples to the contrary; the attempt to suppress Tehelka comes to mind. But ultimately the overall freedom of media, and access to media in India is far, far better than we see in many other less developed countries.

Fourth, and interestingly, weakness can be strength. In America, people came to expect governance to work well, and when it did not, as in the recent scandals of sub prime lending and banking, everybody was surprised and shocked. In India, the fact that people would exploit the system to their own advantage whenever possible is readily understood. The New York Times a few weeks ago had an article on how India has avoided the worst of the problems of sub-prime lending because the Reserve Bank under Dr. Reddy pursued policies that prevented the extreme lending practices in the first place (Joe Nocera 2008). I do not know any inside details on this, but to the extent the article is accurate, it is understandable that the RBI and its regulators would be well aware that a lax regime would be misused.

Next the strong religious and cultural traditions of India can help internalize some norms of good behaviour, and promote what I called 'first-party governance.' Children are brought up in a more religious and cultural environment in families and schools in India than in the West; the modes of behaviour they acquire may promote better governance.

Social networks, likewise based on ethnicity, religion, region etc., can get people to internalize the idea and value of group reputation; that can also help achieve first-party governance. But set against this, we have a weakness of the same networks. The existence of multiple religions, ethnicities, and regional affiliations can hurt, because children and adults may learn to behave well within their own group but not so well when dealing with outsiders. In fact it is almost true that a sense of 'us' has to be accompanied by a sense of 'them'. When an in-group is defined, this is tantamount to a definition of an out-group; these are two sides of the same coin. Then the flip side of a norm that tells you to be honest when dealing with others of the in-group also suggests to you that it is acceptable to cheat when dealing with someone of the out-group. The consequence of this is that dealings will be confined to members of the same group; markets will not be as broad as they should be for full economic efficiency and growth.

Turning to governance weaknesses of India more generally, perhaps the main one is that in the 20 or so years that went before the mid-1980's when the whole apparatus of micro-regulations, and the license raj etc. that was created, the culture of corruption took root. Corrupt institutions and organizations were put in place. And organizations find ways to persist, ways to carry on, long after they have lost their main function or role. Perhaps an example of this is the International Monetary Fund which, it is arguable, should have gone out of business 30 years ago when the Bretton Woods fixed exchange rate regime collapsed. But the IMF survives, inventing many new and different roles for itself. In the same way, the institutions of Indian licensing and planning bureaucracy will try to persist, and will try and extract economic rents as they did before.

Next, there is an ideological division among the Indian intelligentsia who should be the backbone of the system. Many people are wedded to old ideologies; they want to bring back central planning and some vision of socialism, and some of their thinking is then hijacked by special interest groups to advance their own causes.

Frequent elections are a problem. They are exactly the kinds of institutions that promote short-term thinking.

Political divisions across regions are a problem. Frequent elections are a problem. They are exactly the kinds of institutions that promote short-term thinking. Even the best politicians have to be in power to implement their visions; therefore they have to focus on the next election if they are going to do anything. If another election in some state or region that matters to one of the parties in a coalition is always coming up in three months that cannot be conducive to long-term thinking or visionary reform of institutions and policies.

Some Specific Suggestions

Finally, I turn to some specific problems and offer thoughts and suggestions for institutional or policy reforms.

i. How to achieve decisiveness without authoritarianism

To begin with, consider the standard problem of democracies, namely their slow process. It is said that China gets built roads, airports etc always far faster and work far better than those in India because China's authoritarian regime can suppress or override dissent, whereas India's democracy takes a long time to deliberate, and every group that might suffer even the slightest harm from the project can delay or stop it. But I want to argue that you don't have to sacrifice democracy to get efficiency. You can get something close to the best of the two worlds, democracy and decisiveness, through delegation. Central banks in most countries these days are an example of this. They are given operational independence, but ultimately the elected government has the power of appointment and reappointment of the governors of the central banks, and of the members of various committees that govern monetary policy like the one in Britain.

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India can similarly have an Infrastructure commission. You can have commissions that hold hearings on decisions like Special Economic Zones. These decisions are currently in the hands of Chief Ministers of states, and are made non-transparently. Then they are opposed by non-governmental organizations, some of which have warm hearts but lack the kind of hard-headed thinking that is needed for economic development. A commission would have open hearings where everybody gets their say. It would then balance the interests, and issue a decision that is well reasoned. If that is done, the losing side will find it much harder to protest that decision than they do when it is arbitrarily imposed on them.

ii. How India's business community can help improve governance

I have emphasized that governance should not be identified with the government. India's business community should make its own effort to help improve economic governance, especially since they stand to benefit most from better property right protection, contract enforcement, and provision of physical and organizational infrastructure. I can suggest three or four areas for such effort.

Perhaps the main one is group reputation. After the recent financial scandals, it is very easy to see in hindsight how misbehaviour of one person can hurt the reputation of the whole group. There is a lot of worry about being able to attract foreign or even domestic investment when the scandals have made investors fear for the safety of their money in anyone else's hands. To remove this fear and resume capital inflows, the business community needs to have visible and credible internal methods – detection of cheaters, effective sanctions against them, etc. – that uphold this reputation. The business community can often do this better than the courts can. One of the business newspapers just yesterday had a story of how long it would take to bring miscreants of financial scandals to justice in India; I am sure social sanctions that would ostracize and put them out of business would work much faster. The business community needs to realize the value of group reputation and do more to uphold it.

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A lot of disclosures started in a voluntary way. What was the origin of publication of quarterly com-pany accounts? Did it start by the government in America or else-where passing a law that said companies had to do this? No. J. Pierpont Morgan voluntarily started publishing the quarterly accounts of his steel company in 1898, saying that if you are taking money from the public, you owe the public an account of how you use it. Only later when Theodore Roosevelt became president and the progressive movement got going, the government acted to require this of all companies (Jean Strouse 2000: 398, 439). This was a bottom-up innovation that later got adopted into a formal system. Recently the CEO of the American insurance company Aflac allowed shareholders to vote on his annual compensation. This is not binding, but many people are now beginning to say that more CEO's should be doing this, it should be bisnding etc., and that may lead to a law requiring this.

The second hugely important issue is corruption. The source of the problem is that the government or its agents are in a position to allocate something that is scarce and valuable. A great recent example in America arose when the Governor of Illinois was caught on tape saying about his right to appoint somebody to Obama's recently vacated Senate seat: "It's a bleeping valuable thing. You just don't give it away for nothing."[1]

When governments and their agents are in a position to assign something very valuable, it is not surprising that they will be tempted to extract some profit from it. That is only human nature. The only 100% cure from corruption would be to remove from the government all power to make discretionary policy. But that would be going too far. Therefore we have to accept a compromise, trading off the power to make some discretionary policy in response to the major unexpected shocks that may arise, and the resulting corruption on these occasions. In other words, we must accept a second-best solution, seeking only to control the corruption as best as we can using the available resources.

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Dani Rodrik (2003) argues that it is possible to achieve growth up to middle-income level despite some corruption, but much cleaner, much better institutions are needed to go beyond that to a higher-income level. It may well be that India, or at least the economically more advanced part of it is just on the cusp of this transition to and beyond the middle-income level, and therefore businesspeople are beginning to see the need for much better insti-tutions. That could explain why they are particularly unhappy even though the level of corruption may have decreased slightly.

The usual measures to limit corruption consist of penalties imposed on the officials who are detected and convicted of demanding and receiving the bribes. These are "demand-side" solutions. I want to argue that supply and demand sides both matter. You should also look for supply-side solutions to complement the demand-side ones. The business community can attempt this, by developing and enforcing anti-corruption social norms.

1 See the FBI prosecutor's press conference as reported in the Chicago Sun-Times on December 9, 2008, on its web site http://blogs.suntimes.com/sweet/2008/12/fitzgerald_press_conference_on.html

This would work roughly as follows. The business community's norm says that no member of that community will offer a bribe for a government contract or a license, and if anyone is known to have violated this, no other member will do any business with them. Then the winner of the contract won't be able to use that license, because he is surely going to need suppliers, sub-contractors etc. to complete the construction project or whatever. The bribe will be useless, and knowledge of this will deter people from offering bribes to officials in the first place. Of course, this will need leadership from the biggest business names, or the elite business people. Also, it will need a good channel of information that communicates accurately to others when someone gets the contract through bribery rather than through merit.

I have no idea whether this will work. But it has never been tried, and, it seems to me, all the alternatives that people offer are mere hand-wringing: "Oh, isn't corruption terrible. The government should do something." They are not real solutions. Therefore this unusual business-led "supply side" approach may be worth trying. Indeed, something very similar was implemented successfully by guilds in medieval Europe to protect their members from extortion by rulers of city states (Avner Greif, Paul Milgrom & Barry Weingast 1994).

iii. Poverty & Inequality

These issues are not directly to do with governance, but they are important in the context of India's development, so let me say just a little bit about them.

People say that compared to poverty, inequality is a smaller problem; for example that is the title of Arvind Panagariya's chapter on inequality in his wonderful book about India's development (see Arvind Panagariya 2008: Chapter 8). There is some truth to this: poverty can and does kill; it can irreparably damage health, and stunt physical development and education in a way that perpetuates the poverty. Inequality is not life-threatening. But extreme inequality does harm; it creates a perception among the ones at the bottom of the heap that they are no part of this whole game, that they have no stake in society. That can lead them to extreme actions of violent protest, or sometimes even terrorism. These resentments can also be exploited by politicians and ideologues for their own purposes.

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In India, regional inequalities seem a potentially serious problem in this regard, and need to be addressed. I get the impression that at least a very significant part of the problem of the poorer states is that their own state governments have followed bad economic policies. You need seriously to think how those governments can be made to perform better for their own citizens. I do not have an answer, but want to emphasize the question.

iv. Terrorism

Terrorism is another problem not directly connected with governance, but it merits some comment in view of its topicality and importance. I will offer an analogy that some of you may understand, some of you may not: namely, strategies for offence and defence in American football. The offence chooses what to do on each play, whether to run or pass, for example, and they conceal their intentions from the defence. The defence then has to align itself, flexibly to try and respond to the offence's choice. At least they have the advantage that American football has been played for more than 100 years, therefore a lot of experience of what kinds of plays might be run in what kinds of situations has accumulated. With terrorism, we have no data on which to base our estimate of the next tactic the terrorists are going to employ. We have to play defence without the advantage of information from history. The only thing I can think to do is a kind of war-gaming scenario, where you get a bunch of half a dozen extremely smart, extremely young people and ask them to think (a) what they would do if they were terrorists, and (b) figure out how to counter those very strategies.

In fact I think of this as a part of a rather more general policy gaming. I believe that every government department that makes policy, particularly tax policy or regulatory policy should have a group of half-a-dozen very smart young "devil's advocates," whose sole job is to think how each and every proposed policy is misused: "How can I take this tax system and manipulate it for my own profit?" That will then help the department design the tax system to be less manipulable than one devised by a bunch of old bureaucrats who do not think the matter through by putting themselves in the shoes of the individuals and businesses who will take actions in response to the policy.

v. Be eclectic, be flexible, be prepared

Throughout this talk I have emphasized that there are no perfect systems of governance. The problems take many different forms, and solutions must likewise be devised in a non-ideological and adaptable way. Reformers should listen to everybody – the Washington Consensus, its critics, even theorists like me – and then see how all these different approaches and recommendations can be adapted and improved upon to fit their own context.

I want to offer an example of this, from completely outside of economics. Almost a hundred years ago, in December 1911, two explorers ran a race to be the first man to stand on the South Pole: Roald Amundsen from Norway and Robert Scott from Britain. Amundsen, on his previous exploration of the Northwest Passage in the Arctic, had learned how the Eskimos cope with extreme cold: their dress, their dog-sledge driving practices, their food, and so on. He took all this knowledge, combined it with Nordic practices like skiing, and also combined it with modern innovations like the Primus stove. For good measure he added some innovations of his own and ones he had been given by friends, notably a new design of a tent. Scott believed that Britain was the leading country in technology, so he had nothing to learn. In the context of governance, Scott would be like someone who was taking the British or American legal system and transplanting it wholesale to a less developed country.

The results were starkly different. Amundsen won the race by a month. His record of 99 days to the pole from the edge of the Antarctic and back using dog-sledging technology still stands. All his party came back alive. Scott took close to 150 days. It was late in the autumn when he was on the way back. His party was caught in blizzards, and all five of them died (Roland Huntford 1979).

Therefore my advice to institution builders, reformers etc. is: be like Amundsen, not like Scott.

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