22 Growth-oriented legal reforms

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1. Introduction
This chapter deals with the obstacles pertaining to growth-oriented institutional reforms and policies in developing countries and with methods to overcome them.

Economic growth is crucially dependent on institutions, which protect private investors, their property, their contracts and their firms. This is now a widely held consensus among economists (Rodrick, Easterly, Hall, Bardhan), even though the institutional forms which cause this protection may differ from country to country.¹

Makers of wealth must be given chances and should keep most of their profits. Otherwise growth cannot occur. The maker of wealth must be protected against private and public predators. This protection can be achieved by the rule of law but some countries such as China and Vietnam have successfully used other means of credibly protecting private investors.

At first sight, the implications of this insight for modernizing institutions and the law seem to be clear: since the 1990s Western countries and development agencies have poured hundreds of millions of dollars into rule of law projects.² Are they likely to succeed? If one sees the problems of legal and institutional reform exclusively at the implementation level, failure is likely to be around the corner. This view implicitly assumes that poor countries have a weak legal and institutional system because they do not know better and that legal reforms just bridge a know-how gap between rich and poor countries. Or it implicitly assumes that legal reforms are difficult, because the problem of sharing the costs of reform (the free-rider problem) cannot be solved. A know-how gap and a free-rider problem might exist, but both problems cannot explain why legal or other institutional reforms are not carried through or fail in many countries. Often reforms are not in the interest of those who have the power to initiate or block them (Dixit, Acemoglu, Eggertsson).³ Then a country cannot develop the institutions for efficient markets and remains being caught in poverty.

¹ Rodrik et al. (2004); Rodrik (2006); Alesina et al. (1999); Hall and Jones (1999); Bardhan (2004).
² Daniels and Trebilcock (2004).
We deal with the impediments of reform and show that not all wealth-increasing reforms are feasible. Given that a reform does not benefit everyone and bears losses to some, such a reform will not be implemented, if the potential losers are veto players in the political game. This problem cannot be easily overcome through political and institutional negotiations which compensate losers. There is no easy political Coasian bargaining, which guarantees the viability of any wealth-increasing reform. This might be especially difficult in countries with extreme wealth concentration (Alesina, Rodrick, Persson, Tabellini). Moreover, we show that the amount of information about future positions determines who perceives himself as a winner or a loser and consequently who supports or blocks a reform. We also show that a reform can still fail if it makes everybody better off, because problems of coordination, the free-rider problem (splitting the costs) and the bargaining problem (splitting the benefits) can arise.

Another problem pertaining to legal reforms for economic growth arises independently of the above problems of motivation and coordination. To introduce the rule of law is a deep reform. It takes decades and its beneficial effects show up with a time lag. A legal reform agenda, which aims at creating economic growth quickly through comprehensive legal reform, might be overly ambitious and might destabilize a government if results do not surface quickly. To initiate growth, correct phasing of reforms and the development of intermediate institutions to protect property and contracts are therefore important.

2. Pareto-Improving Reforms, Cost-Benefit Reforms and Cost-Benefit Detriments

2.1 Three Types of Reform
Many reforms cut into existing wealth and power positions even if they increase total wealth. Using terminology from welfare economics, we can differentiate between wealth-increasing reforms, Pareto gains without losers and cost-benefit gains. A cost-benefit gain benefits the winners more than it harms the losers. When the winners are more powerful and outnumber the losers, a cost-benefit improvement generates more support than opposition.

We will distinguish three types of legal reforms, using examples from privatization in Russia after 1990. When communism collapsed, ownership of

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4 Alesina and Rodrick (1994); Persson and Tabellini (1994); Coase (1960).
5 Dixit (1987); Acemoglu and Robinson (2000); Eggertsson (2005).
6 As Machiavelli reminds us in *The Prince* (1513), chapter VI, “the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new” (in modo che tu hai inimici tutti quelli che hai offesi in occupare quello principato, e non ti puoi mantenere amici quelli che vi ti hanno messo, per non lì potere sattisfare in quel modo che si erano presupposto e per non potere tu usare contro di loro medicine fortì, sendo loro obligato), available at http://www.liberliber.it/biblioteca/m/machiavelli/il_principe/html/princi_a.htm.
most state enterprises passed into private hands. Konstantin Magin divided the complicated process of privatization into stages. In the first stage, from roughly 1990 to 1994, managers became owners by grabbing state assets, especially in small firms. Restaurants, clothiers, grocers, and other small state businesses were given away or sold cheaply to their managers. Approximately 14,000 Russian enterprises of medium size or larger (at least 50 employees), and many more small firms, passed from state to private ownership.

After privatization, competition among small businesses benefited consumers through lower prices and higher quality. The new owner-managers of these small businesses increased efficiency and profited personally. In reorganizing these businesses, some employees were promoted and others were fired. On average, the privatization of small firms in Russia was beneficial to far more people than it caused harm, and this process generated more political support than opposition.

The story is different when we turn from small to large enterprises. Similar to other centrally planned economies, Russia created industrial giants. State ministries controlled unprofitable conglomerates making steel, automobiles, refrigerators, ships, etc. After the collapse of communism during the 1990s, the industrial ministries sought vast state subsidies to keep these conglomerates operating. The Russian state subsidized them by printing money, not by collecting taxes, which caused hyper-inflation in 1994–5.

Despite resistance from the industrial ministries, managers and reformers in government privatized many large enterprises. In Magin’s second stage, the state created private companies from large enterprises and distributed stock options to employees and other citizens (“voucher privatization”). The privatization process, however, included fraud, intimidation and political chicanery. Against the background of ineffective laws, insiders were able to expropriate the holdings of outsiders. Foreseeing this result, outsiders who owned a few vouchers in large firms sold them to insiders at trivial prices.

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7 Paul Stephan argues that Gorbachev abandoned central planning with the aim of supporting the Communist Party’s power by taxing a market economy, but he could not retain political control for the Communist Party as the economy privatized. See Stephan (1996, 1993).
8 Magin (2003).
9 This is called “spontaneous nomenklatura privatization”.
12 The “control premium” – the difference in the price per share when someone buys a few shares of stock, and the price per share when someone buys a controlling block of shares increases with the number of unresolved corporate governance problems of public companies.
What began as dispersed ownership of options ended in concentrated ownership of stock.13

Many scholars believed that rapid privatization of socialist firms and dispersed ownership of shares would stimulate legal reform in order to protect property rights. They were wrong. Former managers and tycoons with access to finance bought under-priced firms and took control. Their political influence was so great that protecting property rights seemed unnecessary to them. Instead, they blocked the development of laws for capital markets, as well as laws against self-dealing and stripping a firm of its assets. The private owners of large enterprises, who were known as the “oligarchs,” preferred to manipulate politics and demanded property rights only after the Russian state regained power and used it against some of them.14

The economic effects of privatizing large enterprises were mixed. Some industries modernized, ended dependence on subsidies and sold goods at competitive prices. In other industries, closing unprofitable plants caused local unemployment which harmed entire communities, and buyers faced high prices from private firms with monopoly power. Privatizing large enterprises benefited many Russians and harmed others. The process generated controversy and disagreement, not consensus.

Magin’s next stage, 1998–2001, represents the response to this controversy and disagreement. In this period, Boris Yeltsin yielded the presidency of Russia to Vladimir Putin, who vigorously re-asserted central authority and brought the oligarchs under government control.15 With more centralized power, the government slowed runaway inflation by resisting the demands of industries for state subsidies.

In this stage, however, politicization replaced privatization as the dynamic of change for large enterprises. Successful operation of large enterprises now required the protection and participation of politicians. Unrealistic tax laws in Russia created tax liabilities on paper that few firms could pay. Given this fact, politicians were able to threaten the owners of firms with prosecution for tax evasion, fraud and other crimes. To settle their tax arrears and avoid criminal prosecution, politicians sometimes required an owner to transfer his firm or its

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13 Magin (2003) describes several causes of concentrations. The banks that organized auctioning of shares were also buyers, so they manipulated the process to direct shares to themselves or to associated companies. Inflation pauperized workers and caused them to sell their shares to wealthy people. Inflation also caused the state to borrow money from 1995 to 1998. The lenders were the oligarchs who got shares as collateral. When the state defaulted, the oligarchs kept the shares.

14 Hoff and Stiglitz (2002).

15 Some oligarchs were expropriated under threat of imprisonment. Others were bought, notably by giving them the privilege of buying high yielding government bonds. See Shleifer and Treisman (2001: 13).
assets to another firm controlled by politicians.\textsuperscript{16} Politicization disrupts property law and capital markets – why buy what you can take? Politicization also deflects wealth-seeking towards influence, not production. On balance, politicizing firms harms the economy as a whole and benefits some politicians and their friends.

In discussing Russia’s recent history, we distinguish between privatizing small firms, privatizing large enterprises, and politicizing large firms. Concepts from welfare economics explain the essential difference in these three examples.\textsuperscript{17} In the first example of privatizing small firms, many gain and a few lose. Following this logic to its conclusion leads to changes that benefit some people without harming anyone. A “Pareto gain” – to use the technical term for this concept – has winners and no losers.\textsuperscript{18} Some legal reforms approximate Pareto gains, such as privatizing small enterprises in Russia.\textsuperscript{19}

The second example, privatizing large enterprises, has many winners and many losers. Judging on the basis of evidence from around the world, the firms in most industries will ultimately perform better under private ownership than under state control. Almost everywhere, the economy has benefited from private ownership in such industries as steel, automobiles, refrigerators and ships. When a legal change benefits the winners more than it harms the losers, the change is a net gain by the standard of cost-benefit analysis.\textsuperscript{20}

In the third example of politicizing large firms, a few politicians gain a lot and the economy as a whole suffers. When the sum of the costs exceeds the sum of the benefits, the change is a net loss by the cost-benefit standard.\textsuperscript{21}

Table 22.1 depicts the three types of Russian legal reforms: Pareto gains, net gains, and net losses. Here we relate these to the political support and opposition provoked by them. Most people favor reforms when they expect to gain from them, and, conversely, they oppose reforms when they expect to lose. Because few lose from reforms that approximate Pareto gains, such reforms provoke the smallest number of opponents and can often proceed by consensus, an example of which is the privatization of small Russian firms. By contrast,

\begin{itemize}
\item \textsuperscript{16} Frydman et al. (1996a), Frydman et al. (1996b).
\item \textsuperscript{17} Dixit (1987); Acemoglu and Robinson (2000).
\item \textsuperscript{18} Vilfredo Pareto, a 19th century Swiss economist, first recognized the centrality of these changes to economic analysis.
\item \textsuperscript{19} The paradigm in economic theory for Pareto gains is exchange in free markets. In the absence of coercion or misinformation, exchange creates a surplus that the parties share to their mutual benefit.
\item \textsuperscript{20} The paradigm for a net gain is state provision of a local public good such as a road. Commuters ideally gain from driving on a road much more than taxpayers lose from paying for it. Those taxpayers lose who pay for the road, but do not use it, such as pedestrians who do not drive. There is a net gain for society, but some individuals lose.
\item \textsuperscript{21} The paradigm for a net loss is a cartel. The members of the cartel gain less in monopoly profits than consumers lose from higher prices.
\end{itemize}
reforms with net gains divide people into winners and losers, and the former usually outnumber the latter, as, for example, with privatizing large Russian firms. A majority usually (but not always) favors reforms with net gains. Finally, when legal changes cause net losses, the losers usually outnumber the winners, as with politicizing large Russian firms. A minority usually (but not always) favors legal changes with net losses.

Table 22.1  Welfare and politics

<table>
<thead>
<tr>
<th>Name</th>
<th>Economics</th>
<th>Politics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pareto gain</td>
<td>All win</td>
<td>Consensus</td>
</tr>
<tr>
<td>Net gain</td>
<td>More win than lose</td>
<td>Majority</td>
</tr>
<tr>
<td>Net loss</td>
<td>More lose than win</td>
<td>Minority</td>
</tr>
</tbody>
</table>

3. Pareto Reform, Information and Identity
The boundary between Pareto-improving and cost-benefit gains is not as clear and fixed as might appear at first glance. It depends on the level of information in society. If all members of a society are perfectly informed about their own position and how the reforms affect them, the set of Pareto-improving reforms is small compared to cost-benefit reforms. If, however, all members of the society act behind a veil of ignorance, reforms which are in line with general notions of efficiency, equity and fairness become possible. Behind the veil of ignorance the gains and losses from a reform are randomly distributed among the members of society. Consequently, any wealth-increasing reform becomes Pareto improving ex ante and can in principle generate unanimous consent. To illustrate: in the USA and the EU, almost all citizens are sometimes pedestrians and sometimes car drivers. Assume that the most efficient new traffic regulation or safety standard can save the lives of 1000 car drivers and only 100 pedestrians, whereas the second-best regulation would save the lives of 300 pedestrians and 300 car drivers. There is little doubt that almost all US and EU citizens would prefer the first regulation, since they are behind a veil of ignorance and therefore prefer the regulation which saves the highest number of lives. In a country like India, however, poor people are always pedestrians and never car drivers. They cannot profit from a regulation which saves the lives of car drivers. Therefore while a new safety regulation might be uncontroversial in the USA or the EU, where it leads to an ex ante Pareto gain, the same reform proposal might lead to political strife in a country such as India, where it leads only to a cost-benefit gain. And the second reform might be politically preferred even though it saves fewer lives.
Production of legal rules

Provided that all citizens act behind a veil of ignorance for all wealth-increasing reforms, all those reforms become Pareto gains. Such situations seldom arise. But deep crisis can create a situation of general uncertainty about future status and wealth and can wipe out interest groups. Such constitutional moments\(^\text{22}\) in the history of nations can allow far-reaching constitutional reform. Full information and the veil of ignorance are endpoints on a scale of possible information distributions, when deciding whether a reform is of the Pareto-improving or cost-benefit type. Usually, there is some asymmetric information in society, marking an interim stage between full information and the veil of ignorance. Some players are better informed than others about what the consequence of reform might be for them. The more members of society shift from full information to the veil of ignorance, the larger is the set of Pareto-improving reforms and the easier it is to introduce far-reaching wealth-increasing institutional changes.

Politics must not wait for a constitutional moment. A “veil of ignorance” descends when political randomizing obscures the identity of future winners and losers. Growth with random winners and losers is similar to a game where two players each pay a dollar to draw straws and the winner gets five dollars. The game creates an expected gain for everyone in the statistical sense,\(^\text{23}\) or an “expected Pareto gain.” To overcome opposition, include more classes of people in the innovation game by opening competition. Politics too can diffuse the costs of growth. When many people each bear a small proportion of the costs of growth, their opposition will probably remain passive, like urban taxpayers subsidizing farmers. Passing costs onto taxpayers or consumers pacifies opponents by diffusing the costs.\(^\text{24}\)

These policies often combine and interact. Thus, joining the World Trade Organization requires a country to lower its tariffs, which stimulates the economy as a whole and depresses some industries. To overcome opposition, the government may retrain impacted workers (buyoff), pay for retraining with taxes (dispersed costs) and increase uncertainty by lowering many tariffs all at once (randomize).

\(^{22}\) The term “Constitutional Moment” is borrowed from Bruce Ackerman. He, however, uses it in a different way, as a revolutionary and mass supported, but consensual, way of changing the constitution, such as during the birth of the the USA, in contrast to constitutional change by elite political management, such as via the treaties of Rome to Lisbon in modern Europe. See Ackerman (1992).

\(^{23}\) In statistical terms, each player expects to win 1.5, so playing the game makes everyone better off ex ante than not playing the game. Ex post, however, one person wins 4 and the other loses 1.

\(^{24}\) Note that diffuse costs pacify opponents, and diffuse benefits pacify proponents. When diffuse benefits pacify proponents, we have a “free rider problem”: everyone waits for someone else to take the initiative of enacting the growth-promoting reform.
Table 22.2  Circumventing opposition to growth-promoting reforms

<table>
<thead>
<tr>
<th>Policy</th>
<th>Consequence</th>
</tr>
</thead>
<tbody>
<tr>
<td>buy-off/Pareto gain</td>
<td>convert opponents to supporters</td>
</tr>
<tr>
<td>randomize/expected Pareto gain</td>
<td>convert opponents to supporters</td>
</tr>
<tr>
<td>concentrate benefits and diffuse costs</td>
<td>activate supporters and pacify opponents</td>
</tr>
</tbody>
</table>

4. Inequality, Power and Rights Protection

Some authors have argued that differentials in economic inequality can explain differentials in long-term economic growth, for instance the different economic performance of North and South America. Others have argued that it is not inequality of wealth but political inequality that causes such differentials. However, there seems to be an emerging consensus that economic inequality leads to political inequality and that political inequality leads to institutions which protect existing wealth but are not conducive to economic growth.

The fathers of the American constitution did everything they could to protect private property through constitutional safeguards and the division of political power. They understood that wealth owners had to be protected by a strong legal and constitutional asset shield. In the United States, many people who were engaged in the drafting of the constitution were wealthy. George Washington and Thomas Jefferson were millionaires. But none of them was so wealthy as to be able to transform wealth directly into political power. They knew that their property had to be protected by constitutional safeguards and constrained government. But they were not interested in protecting the wealth of particular individuals or families. They protected any property, but not the wealth of a particular group.

In other colonies, where European immigrants settled in large numbers, they set up institutions of property rights protection and contract enforcement that maximized their own wealth and that of their children. Colonies with few settlers were more interested in a strong and exploitative government, which maximized their wealth in the short run.

Many countries with private ownership are different from the USA in the sense that the richest people are so rich that they can transform their wealth into political power and monopoly positions and need no constitutional safeguards to protect it. After the collapse of communism, Russia privatized 14,000 medium

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25 Engerman et al. (1997).
26 Acemoglu and Robinson (2000).
27 Acemoglu et al. (2001).
and large enterprises. It was widely believed that rapid privatization of socialist firms would cause pressure for legal reform and better protection of property rights. It was expected that privatization would cause corporate governance problems. This would lead to a vast number of minority holders who would ask for better corporate governance rules and in general for better protection of property. This did not happen. Former managers and tycoons with access to finance bought under-priced firms and took control. These oligarchs became so rich, and there were so few of them, that they could map their wealth directly into political power to protect it. They could influence politics to such an extent that protection of property rights did not seem necessary for them. They even blocked the development of capital market law and securities law, as well as laws against self-dealing and asset stripping. They did not want strong securities and exchange control and they did not get it. The oligarchs preferred to manipulate politics and demanded property rights only after the Russian state regained power and used it against some of them.

We can observe oligarchic structures in the economies of many developing countries. Claessens et al.’s (2002) findings regarding ownership of corporate assets by the 15 richest families in selected Asian countries is shown in Table 22.3.

Table 22.3  Ownership of company assets by the 15 richest families in selected Asian countries (1996)

<table>
<thead>
<tr>
<th>Country</th>
<th>Ownership of company assets (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>61.7</td>
</tr>
<tr>
<td>The Philippines</td>
<td>55.1</td>
</tr>
<tr>
<td>Thailand</td>
<td>53.3</td>
</tr>
<tr>
<td>Korea</td>
<td>38.4</td>
</tr>
<tr>
<td>Singapore</td>
<td>29.9</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>34.4</td>
</tr>
<tr>
<td>Malaysia</td>
<td>28.3</td>
</tr>
<tr>
<td>Taiwan</td>
<td>20.1</td>
</tr>
<tr>
<td>Japan</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Note: This compares with 2–3% ownership of company assets by the 15 richest families in the USA.

Source: Claessens et al. (2000).

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28 Hoff and Stiglitz (2002).
29 Claessens et al. (2000).
This leads to a more general observation. If a small group of families owns the land and the capital stock of a country, this group is not interested in the legal protection of property rights. Wealth translates directly into power. Such groups can sometimes better serve their interests if they coordinate their mutual problems outside the law and manipulate politics rather than submit to the rule of law. They are not interested in constraining government discretion by the strong rule of law. Even a law which effectively protects their property is less valuable for them than direct protection through a discretionary state working in their interests. Property law protects each and every property. It does not protect monopoly positions. It provides chances for small properties to get bigger. It does not protect large properties against risk and it undermines the position of oligarchs and monopolists.

If oligarchs are interested in laws at all, they take an interest in the legal protection of their monopoly positions, not in the legal protection of those who might destroy them. Therefore a fundamental difference exists between laws that protect property and laws that protect wealth. Economic theory tells us that private cartels are inherently unstable, as it always pays to defect. They become more stable if they are supported and enforced by law. Import restrictions, import duties, licensing laws and unfair trade practice laws are the kinds of law demanded by oligarchs. Such legal norms can cement monopolies and stabilize cartels. The legal system they represent is a rule by law rather than the rule of law. In an oligarchic society with monopolistic firms the commitment problem can render it impossible to introduce a growth-oriented rule of law in exchange for side payments, even if the gains might be gigantic.

In more general terms, it seems that oligarchic societies, in which a small minority owns the majority of land and capital, have great difficulties in establishing legal rules which trigger entrepreneurial innovations outside the dominant industries. Empirically negative correlations between growth and inequality in cross-country studies have been found by Alesina and Rodrick (1994), Persson and Tabellini (1994) and Perotti (1996).  

Extreme inequality leads to concentration of political power and blocks a rule of law conducive to growth. A symmetric pattern emerges in societies with extreme equality.

Extreme equality of wealth is by definition not compatible with the protection of property rights. Whenever a property right leads to its owner having more than average wealth, equality requires the dilution of such wealth by taxes and wealth-sharing rules. This destroys the profitability of new ideas.

The establishment of constrained government and the rule of law is therefore not a know-how problem. And there is no guarantee that a political system can

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change the institutions to promote growth, however large the overall benefits might be.

If small groups benefit greatly from lawlessness and large groups benefit from the rule of law, but with a smaller gain per capita, this adds to the collective choice problem inherent in any provision of public goods. The potential winners have less incentive to organize than the potential losers.

Table 22.4  Power, politics, and law

<table>
<thead>
<tr>
<th>Power</th>
<th>Politics</th>
<th>Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>extreme inequality</td>
<td>oligarchy</td>
<td>power and no law</td>
</tr>
<tr>
<td>moderate inequality</td>
<td>majority</td>
<td>law and rights</td>
</tr>
<tr>
<td>Strict equality</td>
<td>minority</td>
<td>law and no rights</td>
</tr>
</tbody>
</table>

5. Logic of Reform in China

Now we turn to some important historical examples of overcoming opposition to growth-promoting reforms. Chinese reforms generated economic growth rates of 9% per year for more than 25 years, reduced absolute poverty from 25% to less than 5% of the population, and increased life expectancy from 64 to over 70 years. China proceeded by “dual track development,” which means adopting a different approach for the traditional socialist sector of heavy industry and for the free sector of light industry. The socialist sector mostly continued under state planning in its traditional way. As socialist industries stagnated, workers, directors and party members kept their jobs. Meanwhile China unleashed the free sector, especially in light industries. The free sector escaped bureaucratic controls and retained most of its profits. Under the dual track system, the socialist sector remains shielded from competition and declines gradually, while the free sector grows quickly, raises national income, and creates better jobs for the young and adventurous.

The dual track system can be viewed as a political deal between the socialist and free sectors to share the benefits of growth. Instead of abruptly privatizing the socialist sector, the state gradually shrinks its employment while sustaining wages. Meanwhile, incomes increase rapidly for entrepreneurs and successful employees in the free sector. The party and the state bureaucracy allow people to keep most of the wealth that they make – the burden from taxes and corruption is modest. Party chairman Deng Xiao Ping promoted reforms with the slogan: “For everyone to get rich, some must get rich first.” This aphorism suggests

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31 Qian (2001).
that reforms will benefit everyone at uneven rates. Everyone gets a little richer and inequality increases as entrepreneurs in the free sector get a lot richer first.

Communist and state officials support the free sector because they benefit from its growth. In the free sector, individuals often share ownership of firms with local and regional governments. Entrepreneurs thus include private people and some officials in the Communist Party and the state. People who acquire political power in the Communist Party and the state also have opportunities to acquire wealth.

Like China, Pareto growth was the development strategy adopted in Japan, the Republic of Korea, Taiwan, Hong Kong and Singapore. As they opened their markets to domestic and international competition in the 1950s, these countries developed instruments to share the surplus and diffuse the costs, so almost everyone gained. The instruments were in part public services such as schools, hospitals and rural infrastructure, and in part, they were legal forms, such as land reform and judicial independence. Also these countries protected new wealth from confiscation and predation. These policies encouraged economic transformation without legal or political disruption. The result approximates a Pareto gain with an unequal distribution of the surplus.32

It should also be noted that many people in East Asia were able to start new businesses and rise in the social hierarchy. Open competition among entrepreneurs, which requires a legal framework that protects economic liberty, naturally randomizes the winners and losers from growth. China offers its people an economic lottery with good odds on winning, so they are eager to play. Growth-promoting reforms spread a veil of ignorance over future winners and losers.33

6. The Loser’s Dilemma in Economic Growth
We explained how the Chinese government successfully used three strategies to overcome opposition to growth-promoting reforms. Why isn’t every country like China? Why do governments reject growth-promoting reforms with Pareto

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32 In the language of Campos and Root (1996: 175), these countries made “credible commitments” to property owners that secured “the political foundation of economic rights.” Campos and Root stress the advantages of policies that not only cause Pareto gains, but also convince the public of the state’s commitment to such policies. Their account of Asia’s success is very similar to ours.

33 The “veil of ignorance” is the famous phrase used by John Rawls in his magisterial book, A Theory of Justice (1971). Rawls connects ignorance with fairness, because people are more nearly impartial about a law when they do not know who will win and lose. Ackerman suggests that the veil of ignorance can descend historically when a society faces a large constitutional crisis and everyone is uncertain about the future. This is one kind of “constitutional moment.” See Ackerman (1992).
Reforms usually require a political bargain with an inherent obstacle that we will explain by the “dictator’s dilemma.”

General Augusto Pinochet staged a military coup against the government of Chile in 1973. After ruling the country as dictator for more than a decade, he eventually returned political offices to civilians in a process ending with his resignation as head of state in 1990. He remained head of the army until he stepped down from that position in 1998. In 2004 he was arrested and charged with various crimes. He died in 2006 before most criminal charges were resolved by courts. This story depicts a dilemma: an aging dictator wants to resign from power, and his countrymen agree, but he fears prosecution for crimes. The dictator’s dilemma is that his only effective guarantee against prosecution is to retain the power that he wants to relinquish.

The dictator’s dilemma exemplifies a general problem of trust in politics. The proponents of growth-promoting legal reforms may want to buy off the opposition, but the reformers may be unable to commit legally to providing the losers with subsidies, retraining, tax breaks, protection against competition, etc. They cannot commit because the law preserves their right to change their minds later. A future government can legally repeal almost any policy or law made by the current government. The many who benefit from growth may want to buy off the few who oppose it, but the political bargain is not legally enforceable. The loser’s dilemma in economic growth is that growth erodes the political power that guarantees his share in the gains.

A historical example from India illustrates this problem. Before independence, India contained many states where maharajas ruled and owned much of the land. Abolishing these states had many advantages for India, including removing local impediments to development. Societies in which a small minority owns most of the land and capital often have difficulties establishing legal rules that broadly trigger entrepreneurial innovations broadly. As compensation for the transfer of their states into the Union of India and their loss of tax income in 1947, the maharajas were granted a subsidy called the “Privy Purse.” However, the subsidy was revoked in 1975. In general, political commitment is especially problematic when the bargain extends for years, as with the Privy Purse. 

Economists sometimes summarize these facts by saying “There is no political Coase Theorem.” The Coase Theorem is the proposition that people can always achieve the surplus from bargains when transaction costs are not too high. This proposition is more true of individual choices than of collective choices. Coase (1960).

A legislature sometimes enacts a statute forbidding its repeal by a future legislature, but most constitutions give the legislature broad powers that effectively preclude such “entrenchment.”

The government tried to abolish the privy purse by an executive order, which the Supreme Court ruled unconstitutional in 1971. Parliament subsequently abolished it by an amendment of the Indian constitution in 1975 (Sorabjee 2006).
7. Calming Disagreements about Redistribution

Like the double-trust dilemma of innovation, the dictator’s dilemma is a problem of trust with no perfect solution. The best solution aligns the interests of the reformers and the groups harmed by growth-promoting reforms. To align interests, the parties bargain and make agreements, but they are seldom legally enforceable. Political deals often need to encompass groups with a history of confrontation, not cooperation. The dictator’s dilemma is more severe than the innovator’s dilemma because politics involves more confrontation and less cooperation than business. To avoid prosecution, Pinochet needed political cooperation from families whose members he had imprisoned.

Trust has no magic solution, but a general strategy for building it in business also applies to politics. Two executives begin discussing the promising and dangerous possibility of merging their companies. They agree to meet for lunch each Tuesday to discuss the matter. Should they take turns to pay the bill for lunch, or should each buy his own lunch? Behavior at lunch may reveal something about their traits that helps to predict behavior in a merger. By taking turns to pay, they will be able to see whether the other party orders inexpensive wine when he pays and expensive wine when the other party pays. After a lot of lunches, they may start to trust each other. The general strategy for building trust is to break reliance down into many small steps and spread them over time.

People concentrate on making wealth when they believe that they will be able to keep most of it. Security in property builds gradually over years, like building trust over many lunches. To illustrate, in common law countries like Canada and India, judges create fundamental property law through the gradual accretion of precedents. Over time, the common law creates a baseline of secure property rights. Security of property requires the calming of redistributive disputes. Calm descends when most people accept the broad division of wealth that property law yields. Once citizens feel secure against others taking their property, they can accept moderately adverse redistributions of wealth by taxes, government expenditures, statutes and regulations. In general, introducing the rule of law into a society is a deep reform which takes decades. Conversely, a political agenda that

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37 The dictator’s dilemma is a single-trust problem: The dictator gives up power first and trusts the civilian government not to prosecute him. In contrast, innovation is a double-trust problem.

38 In terms of game theory, politics has relatively more zero-sum games (redistribution), and business has more positive-sum games (production). The political philosopher Carl Schmitt famously defined the political as the sphere of conflict in which people confront each other as enemies.
goes too fast might destroy the trust necessary to secure property, and the reform might collapse like a sprinter on the starting blocks who leans too far forward.

We began by contrasting examples of gradual reforms in China and abrupt reforms in Russia. A similar historical case contrasts agricultural reform in France in the late 18th century and Prussia in the early 19th century. The French national assembly abolished the feudal system in a sweeping reform in 1789. By abolishing feudal obligations, the peasants ceased to be serfs. In addition, the reforms redistributed aristocratic lands among the peasants, which impoverished aristocrats. (Besides losing their wealth, many lost their heads.) The reforms created the framework for markets in land and also disrupted property rights and unleashed redistributive disputes. Production grew in the long run, but slowly. In 1851, agricultural productivity per worker in France still amounted to only 44% of the British level.  

Prussia, in contrast, wanted modernization without revolution, so it crafted reforms that benefited both peasants and aristocrats. Under the feudal system, serfs kept part of the harvest and gave the rest to their lords. Furthermore, each side was tied to the other by feudal bonds that restricted freedom of contract. To modernize the system, reforms from 1807 to 1822 applied a simple formula: the peasants had to buy themselves out of serfdom by transferring up to half of the land to the lords. Both sides were freed from feudal restrictions, including compulsory labor. Like France, Prussian land reform created a framework for markets in agricultural land and labor, but, unlike France, Prussian reforms enlisted the support of landlords and peasants by benefiting both. As a result, the transition was relatively smooth and production rose. Two widely used measures of productivity, production per worker and production per unit of arable farm land, increased by 60% and 44% respectively over the relevant period between 1800 and 1850. In contrast, during the four previous centuries, agricultural productivity had barely advanced.  

The rule of law comes partly from constitutions that distribute power to offices and rights to citizens. For example, the constitution of the United States played this role to calm the uncertainties created by the American Revolution. Many of the statesmen who created the USA’s constitution were wealthy, but no one was rich enough to transform his wealth directly into political power. They secured their property through the division of political power and constitutional rights. As constitutional protection proved effective, redistributive disputes calmed down and economic growth soared.

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40 Figures taken from Helling (1966: 134 and 139). The latter figure refers to cereal products only for the whole of Germany. It remains, however, debatable how much of these productivity gains can be attributed to the reforms.
41 See Federalist Papers 10 and 51.
Iceland in the 17th and 18th centuries is a case where vested interests blocked economic reform, with tragic consequences described by Eggertsson.\textsuperscript{42} From the late Middle Ages to the 19th century, laws required all laborers and servants to live and work on farms. They could not leave the farms and work in the fishing industry. This law kept agricultural wages low, which benefited the small number of people who owned land – in 1700 around 80 individuals owned 50% of the total arable land. People were forbidden to become fishermen even in years of famine when they suffered from hunger while local waters teemed with fish. Shifting labor to more productive uses could, in principle, have benefited workers and landlords, but, instead of finding a way to share the gains, the landlords opposed change. A similar story is told about the Caribbean plantation islands in the 18th century, where an oligarchy of landowners resisted new opportunities and technologies. In general, oligarchic societies in which a small minority owns most of the land and capital have difficulty establishing legal rules that trigger entrepreneurial innovations outside of the dominant industries that they control.

8. Conclusions
The many who win from economic growth can overcome the few who lose, and economic analysis shows how. Three principles provide a guide to activating support and pacifying opposition to pro-growth reforms. First, a more comprehensive political bargain that uses subsidies, taxes, and privileges turns losers from economic growth into winners (Pareto gain), which turns opponents into supporters. Second, short of turning losers into winners, a more comprehensive bargain spreads the losses, which pacifies opponents. Third, more open competition among entrepreneurs gives more people the possibility of winning the innovation lottery (expected Pareto gain), which turns opponents into supporters. Conversely, concentrating the losses from economic growth on a small group of people activates their opposition and, if they are powerful, they may frustrate policies that benefit the nation. In principle, giving them more of the gains from economic growth can buy them off or pacify them, but doing so requires guaranteeing a share of the gains from growth. Guarantees are difficult since every policy or law can be repealed or amended. In politics, credible guarantees mostly depend on the recipient’s power against the guarantor, which poses a dilemma. Since power accompanies wealth in politics, economic growth that realigns wealth also redistributes power. The loser’s dilemma is that economic growth erodes the power that guarantees his share in the gains. While this dilemma has no perfect solution, something can be done. Doing something requires evolving institutions, not just enacting laws. Laws

\textsuperscript{42} Eggertsson (2005) chapter 7.
and social norms must be braided into institutions that strengthen each other like the strands in a rope. Trust develops from a history of cooperation, like taking turns to buy lunch. If not cooperation, then a history of fair competition can develop trust, like tennis players refereeing their own games. By solving trust problems, law helps to end the poverty of nations through economic innovation and political reforms.

References


