

GLOBALISATION AND INSTITUTIONAL CHANGE: A DEVELOPMENT PERSPECTIVE*

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1. INTRODUCTION

1.1 *Development as hope*

It is generally acknowledged that sustained institutional change is required for national economic and social development. But the consensus disappears when you attempt to specify the prerequisites of institutional reform or the policies capable of bringing about sustained change. In addition, under globalisation, the responsibility of whatever global institutions might exist in promoting – or hindering – national development is a subject of great controversy. The apportionment of relative responsibilities at global, national and local government levels has philosophical roots, which are often neglected in the debate. Yet the practical implications of global markets escape no one concerned about development.

If the main responsibility for change is global, in effect, citizens and policymakers in developing countries can only wait for a better international order, perhaps even in the form of a world legitimate government providing for global public goods. Conversely, if the main responsibility rests with concrete citizens and policymakers, then the focus shifts from global to

* An earlier version was presented at the General Assembly of the Pontifical Academy of Social Sciences, The Vatican, on 'Globalization and the Common Humanity: Ethical and Institutional Concerns', 25-28 April, 2001. I am grateful to Louis Sabourin for constant encouragement and to Hanna Suchocka, Juan Llach, Paulus Zulu and other participants for their comments, which helped me clarify the argument in parts. Joint work carried out at the OECD Development Centre is acknowledged in the references and was essential in reaching the current form, but neither the OECD nor its Development Centre are accountable for the text.

national, local or regional governance. Greater proximity to decision making brings hope, but it also calls for deeper and more immediate institutional changes.

It would be naive to think that better data, sounder analysis, or finer attention to culture could solve this riddle. Yet data, analysis and culture are all three needed to address issues of globalisation, given the emotional overtones that the term has acquired in the last few years.

The perspective of this paper (some might call it a basic premise thereof) is that, in the absence of an unambiguous answer stemming from data, analysis or even culture, hope is essential for the betterment of every man. This hope is entangled with the emerging awareness about a 'global common good'. Indeed, as Pope John Paul II said on 27 April, 2001, the Catholic Church hopes 'that all creative elements of society will co-operate to *promote a globalisation which will be at the service of the whole person and of all people* (emphasis in the original)'.

The perspective of this paper has an immediate consequence: whatever the national citizens and policymakers must do, perhaps in association with like-minded others, they should do, rather than waiting for the 'just global order' to fall from the sky. This change of attitude has occurred in my own country in the course of one generation. Thirty years ago, probably no one here would have thought that Portugal would attain the forefront of European integration, as it undoubtedly has today.

The gains in economic welfare experienced after the country joined the European co-operation movements following the Second World War were nothing short of spectacular. Yet, the lack of mutual political responsiveness and the geographic distance to European centres led several analysts to question its European culture, and to discount its ability to converge towards European best practices.

For different reasons, the same was said – even ten years ago – about Greece and about the countries of central and Eastern Europe. Adjustments to globalisation continue to be needed in these countries and indeed in their partners in the OECD. Due to their reputation for good corporate and political governance and their habit of international co-operation, however, some countries manage to adjust economic structure. But the willingness and ability to adjust to shocks cannot be taken for granted, even within the OECD. Several members, like Mexico, Korea and Turkey, let alone members of the OECD Development Centre like Argentina, Brazil and Chile, have experienced financial crises in the recent past. While their financial reputation remains fragile, most of these countries are confronting the challenges

by pressing on with structural reforms resisted by vested interests but essential for the promotion of the common good of their citizens.

Similarly, other emerging, transition and developing countries will find the self-confidence to bring out the changes needed for sustained development even though they may now be dismissed as hopelessly backward – economically, politically, perhaps even socially. This is the reason why hope in development is so important. Without it, no matter how clear the reforms might be to the outside observer, to the informed citizen, or even to the policymaker, they will not gather sufficient popular support to be carried out on a sustained basis.

This also matches the Portuguese experience, where international financial markets gave Portugal a sound financial reputation in the early 1990s, before the people actually believed that the newly found prosperity would not be wiped out by the kind of political upheaval experienced through most of the 20th century. I do not intend to draw further on my national experience, even though it supports my perspective of hope. Rather my objective is to present some general propositions about the effect of globalisation on institutional change. But I thought the way in which Portugal responded to external pressure over the last decades provides some additional motivation, if it were needed, to equate a development perspective with hope, as a fundamental dimension of human freedom throughout the world.

1.2 *An interdisciplinary experience*

In a path-breaking initiative for economics as a social science, the Vatican convened on 5 November, 1990 a colloquium based on a questionnaire sent to thirteen economists representing the best professional opinion world-wide about *Social and Ethical Aspects of Economics*. The responses provide a variety of views on the role of markets in economic growth and development and were used in the preparation of the 100th anniversary of the Encyclical Letter *Rerum Novarum*, given on Mayday, 1891. Pope John Paul II chose to call his Encyclical Letter for that occasion *Centesimus Annus*.

The proceedings of the Vatican colloquium reveal a consensus: markets operate in particular environments and their performances depend on that of other institutions – economic, social and political. Ten years after *Centesimus Annus*, I continue to hold that the emphasis of the Encyclical Letter on the natural and human environments, together with its rejection of central planning as a viable alternative to the market, remain major

innovations in the economic and social thinking of the Catholic Church. Recalling *Centesimus Annus* on 27 April, 2001, Pope John Paul II noted 'that the market economy is a way of adequately responding to people's economic needs while respecting their free initiative but that it had to be controlled by the community, the social body with its common good'.

In a tribute to my father, who never ceased to remind me of the concrete importance of ethical and social issues, I once summarised my own views on 'Economics, Ethics and their Policy Implications'. To capture interdisciplinary research and historical awareness, Macedo (1992) quoted No. 59 of *Centesimus Annus*. This human dimension, present throughout the Encyclical (No. 53 calls it 'real', 'concrete' and 'historical', see also Martini, 1999, p. 283), implies a better future for 'each man', rather than for the 'abstract' man postulated by soviet central planners.

The concrete human dimension I learned from my father contrasts with the 'end of history' view of Francis Fukuyama (1989). With the fall of the Berlin Wall and the demise of the Soviet Union, the world-wide triumph of liberal democracy and the advent of true global economic progress seemed to follow the triumph of the market over the state. The recommendations of the Bretton-Woods institutions combined with American preferences to form what came to be known as the 'Washington Consensus'.

Yet, no such consensus existed among economists and policymakers. On the contrary, most contributions to the volume on *Social and Ethical Aspects of Economics* (Musu and Zamagni, 1992) suggested that effective states as well as efficient markets were both crucial ingredients for a successful human society. Then and now, the crucial policy issue is how states and markets should interact when the latter become global. The desired interaction, it is surmised, will result from changes in corporate and political governance.

As global markets remain only part of concrete policy environments, institutional changes at global level are not prerequisites for most policy reforms. Indeed, the *principle of proximity*, with profound roots in the thinking of the Catholic Church, suggests the opposite – governance responses at the local level, through the combined action of elected officials and civil society. Moreover, the European example makes clear that the common good may be provided by regional institutions.

Even if the existence of a 'global common good' becomes more widely acknowledged, there is no way the existing global institutions can provide for the common good without relying on national and local entities. Sometimes, perhaps because of contradictory positions of the member

states, the UN, WTO, IMF and World Bank are unable to co-operate with each other. But in specific areas of the competence of the UN system, its Secretary-General cannot carry out minimal global governance tasks, as was recently recognised by Gordon Smith and Moises Naim (1999).

Fortunately, there have been occasions when the global economic and financial institutions have co-operated with the UN system. Some pertain to conflict resolution on the ground (e.g. El Salvador, East Timor), others to joint ventures. Among the latter, two examples come to mind: the joint publication of *A Better World for All* by the IMF, OECD, UN and World Bank and the preparation, which has involved IMF, World Bank and WTO, of the UN Conference on Financing for Development to be held in Mexico in Spring 2002 (Macedo, 2001a).

Nevertheless, the democratic accountability of global institutions, let alone of regional ones, remains very far into the future. National legitimacy remains the source of democratic accountability. If we postulate both, national governance becomes the norm. The appropriate level of governance response should only be changed when the level of the nation-state is found to be sufficiently inadequate, due to changes in technology, in preferences, or both.

As mentioned, the quality of governance can be improved by solving the problem closer to the citizen than the often cumbersome national administration would allow. This is why the principle of proximity is explicitly recognised in the 1992 Treaty on European Union (in the current version see articles 1, second paragraph and 2, second paragraph, which mentions the principle of subsidiarity and refers to article 5 of the 1957 *Treaty establishing the European Community*; see also No. 48 of *Centesimus Annus*).

But, for many issues, improving governance calls for international policy co-operation and even for international institutions. The quest for appropriate regional institutions echoes both concerns as there are subnational and supranational regions. Among the latter, the institutional framework of the EU and of the OECD deserve notice because both are built on the belief that peer pressure among them can bring about better policies. In addition, the EU's combination of unity with diversity (Bliss and Macedo, 1990) may be an appropriate response for what Pope John Paul II calls a 'globalisation of solidarity' (Martini, 2000). In order to ensure this, a greater awareness of the common European good is called for. This presumes that the EU will play its part in the globalisation of solidarity, from its own enlargement to the reinforcement of its development policies. At the moment, the amounts reported to the OECD Development Assistance Committee (DAC) cannot be

meaningfully consolidated and therefore remain scattered and with less impact. It is worth citing that, according to the 2000 numbers released on 25 April, 2001 on the occasion of the DAC high level meeting, the EU states and the European Commission (EC) accounted for \$30 billion, compared with \$23 billion divided roughly equally between US and Japan.

1.3 *Outline*

This paper is a contribution to the understanding of the challenge to reinforce policy reform and therefore sustain development. It is open to interdisciplinary research, even though most of the references come from economic literature, and it is organised into 6 sections. Section 2 introduces stylised facts about the interaction between globalisation and governance and discusses the economic pillars of democratic governance in developing countries.

Section 3 presents an empirical assessment of the strength of the link between globalisation and corruption, based on ongoing work carried out with Federico Bonaglia and Maurizio Bussolo (BBB hereafter) at the OECD Development Centre as part of the 2001/2002 activity 'Empowering people to take advantage of globalisation'. The empirical support for the fact that increases in import openness do indeed cause reductions in corruption, a crucial aspect of governance, is robust and the magnitude of the effect is sizeable. After controlling for cross-country differences, openness' influence on corruption is close to that exercised by the level of development. The policy implication is that trade liberalisation should remain a priority for both developed and developing countries.

Section 4, on corruption and governance, draws on work carried out at the OECD Development Centre by Irène Hors as part of a 1999/2000 activity. It stresses the role of private enterprise and then provides a brief account of the Argentine experience in the fight against corruption based on interviews with Luis Moreno Ocampo, the leader of the local chapter of Transparency International (TI). The broad implication is that property rights cannot be divorced from civil rights. Indeed, No. 48 of *Centesimus Annus* lists the institutional prerequisites of a market economy as 'the guarantee of personal freedom and property, aside from a stable currency and efficient public services'.

Section 5 reviews the European experience with emphasis on its portability, as an illustration of the role regional agreements may play as better governance responses to globalisation. Macedo (2001c) proposes a

'Eurocentric' perspective on international financial architecture based on the unwritten code of conduct governing exchange rate policy among EU members in the early 1990s. Work being carried out at the OECD Development Centre with Daniel Cohen and Helmut Reisen (BCR hereafter) applies this perspective to emerging and developing countries, in particular Argentina and the Franc zone in Africa. The perspective is now carried out beyond the domain of monetary regimes.

The overall approach stresses the role of external pressure in bringing about structural reforms, which might be resisted by the operation of domestic vested interests. The 'voracity effect' uncovered by Aaron Tornell and Philip Lane (1999) can apply to development aid, or indeed to structural funds (as suggested in Macedo 1999 for the case of Portugal). In this regard, therefore, the role of external pressure comes back in the concluding Section 6 as one of the foundations for hope in development.

2. GLOBALISATION AND GOVERNANCE (G&G)

2.1 *More than an acronym?*

The programme of work of the OECD Development Centre has been devoted to the overarching theme of 'globalisation and governance'. The expression, if not the acronym G&G (which sounds like a brand of Italian shoes), has been independently used in the programme for the March 2001 plenary meeting of the Trilateral Commission, whose European chairman established the programme with intellectual input from Joe Nye. My 'Eurocentric' preferences notwithstanding, I do agree that 'the information revolution creates a new politics of credibility in which transparency will increasingly be a power asset' (Keohane and Nye, 1999). The *OECD Global Forum 2001*, on the general topic of 'Sustainable Development and the New Economy', also has a panel on G&G.

The present paper – like BBB – contributes to a major activity on 'Empowering people to take advantage of globalisation' included in the programme of work on G&G for the years 2001-2002. In addition, other activities, on exploring how public-private partnerships can bring forward market reforms policies, how to enhance transparency in public procurement and fight corruption, are relevant to the broad topic addressed here.

The policy recommendations emerging from the 1999-2000 programme of work of the OECD Development Centre (also devoted to G&G) already indi-

cated that sustainable development in a globalising economy requires good governance, both at the international and national level. Without appropriate governance structures, developing countries will find it difficult to participate in and to benefit from the process of globalisation while ensuring a fair distribution of these benefits among the different segments of the populations.

G&G affect each other in a complex mutual relationship, the result of which may be a better, or worse, economic performance. Securing a positive interaction is even more challenging in developing countries seeking to alleviate poverty. In effect, a development-inducing G&G interaction may require deeper institutional change than policymakers and citizens can deliver. This is why, from a development perspective, governance issues are inseparable from ways and means to promote institutional reforms. In this regard, the pressure of globalisation appears to be greatest on reforms leading to more foreign trade in goods, services and assets than on reforms impinging on other aspects of the national economic and social structure – which may be of greater relevance to citizens.

It is this differentiated pressure from markets and voters that must be resolved for a positive G&G interaction to obtain. When the interaction is negative, on the contrary, demands from international financial institutions bring about social unrest, which in turn stalls structural adjustment and institutional reform. As a consequence of this fundamental ambiguity, national policymakers may be tempted to retract on international exchange when structural reforms face greater resistance from citizens. Yet, the temptation to delay reforms cannot be overcome through defensive measures against globalisation. Rather an improvement in governance bringing about the needed institutional change is the dominant strategy.

To help bring about sustained national development, this paper suggests both national and regional governance responses to globalisation. The national response that is emphasised involves fighting against corruption whereas regional integration is seen as a way of introducing peer pressure for better policies. This implies going beyond the trade agenda into deeper issues of policy reform. The question would then become whether peer pressure at the regional level can bring about national institutions responsive to global challenges. Answering this question is more likely to provide policymakers with a handle on how to bring about the positive G&G interaction, rather than simply liberalising their economic regime in the hope that the appropriate institutional change will materialise.

That being said, the importance of trade liberalisation cannot be underestimated: increased imports deliver a decline in corruption of roughly the

same magnitude as increased income. These virtues of outward orientation as quality enhancer for domestic institutions and growth should certainly be further examined, and in-depth country specific case studies should compare alternative policy paths. T.N. Srinivasan and Jagdish Baghwati (2000), who examine the links between openness and growth, are confident that the basic findings will not be refuted. The same applies here.

2.2 Economic pillars of democratic governance in developing countries

Most countries are gathered around the seven richest OECD economies (G-7), whose leaders have regularly met over the last quarter century, suggesting a response to international interdependence rooted on sovereign nation states and on military treaties among them. The hegemony of the US is strongest in military issues, which have greater salience outside the OECD.

The definition of complex interdependence by Keohane and Nye (1977) is precisely a minor role of military force; the absence of hierarchy among issues and multiple channels of contact among societies. These conditions have roughly been met among OECD countries since the 1970s but the information revolution of the 1990s is changing political processes in a way in which 'soft power' becomes more important in relation to hard power than it was in the past. In the current environment, 'credibility becomes a key power resource both for governments and NGOs, giving more open, transparent organisations an advantage with respect to free information' (Keohane and Nye, 1999, p. 213). The adequate provision of common goods depends again on information, since whether information is commercial or strategic determines whether a good is private or public and, in the latter case, at what level of government it is best provided.

The increase in trade, foreign direct investment, and even labour migration is including more and more countries in various stages of economic development. This deepening and widening of international economic interdependence was facilitated by improvements in telecommunications and information technology, has led to a more rapid transfer of knowledge, and has increased the global sharing of political and management ideas.

Alongside the trend of globalisation, many developing countries have embraced democratic governance over the past decade. Even in countries that do not yet have free elections, there is more demand by civil society for information and voice in decisions about public policy, and progress toward more open discussion. In all kinds of political systems, issues of transparency and accountability have moved to the centre of the public agenda.

These policy reforms will have to be complemented by rules and institutions, which provide options and incentives at the micro level, so as to encourage participation and, ultimately, help spread income gains.

The perception that globalisation, not poor governance, has reinforced inequality is behind much of the current debate. For that reason, it is important to demonstrate how the G&G interaction can lead to inclusive globalisation. The 'supply response' of developing countries to globalisation hinges on governance and on institutions as much as it hinges on resource endowment and available technology. In other words, the G&G interaction is positive or negative depending on whether or not foreign investors on the one hand and governments on the other manage to sustain democracy and social cohesion. This is another way of looking at the differentiated pressure from markets and voters mentioned in Section 2.1 above.

To focus on the economic pillars of democratic governance, key elements of democratic governance structures will have to be identified in the specific G&G interaction applying to each individual country or region. It would appear that the process of participatory development is not feasible without transparency and accountability. Also, democratic governance and the acquisition of skills are intimately linked to empowerment of people and, thus, to poverty reduction.

Governments of developing countries are often told that unless they submit to certain economic strictures, they will be punished by global markets. Even within countries that have adopted major parts of that economic agenda, a substantial majority of citizens share only the costs, but not the benefits, of globalisation. Moreover, opportunities to overcome economic exclusion are lost when international donors impose standardised reform policies that may fit poorly within existing political and social constraints.

That being said, it is essential to know whether those opportunities for poverty reduction actually existed in practice. One way to ascertain this is to look at what foreign investors are doing in terms of education and training policies, or even promotion of health care or infrastructure. All these aspects increase the ability of local residents, especially the less skilled and vulnerable, to participate in the global economy. This is why these aspects may become a benchmark for what governments should do through increased participation in the framework of democratic governance structures, public education, and support for private educational policies and institutions, including co-operation with foreign investors.

Of course, the contribution of the tax and transfer mechanism to the provision of social welfare, health, and education, as well as training pro-

If developing countries do not take advantage of the opportunities offered by globalisation, they risk having all or a part of their population being left behind, increasing social exclusion within their country and widening global inequality across countries. Such adverse developments could threaten democratic institutions and slow necessary reforms, which amounts to a deterioration in governance.

Another way to illustrate the G&G interaction is to note that the respect of property rights and open markets for goods, services and assets have become widely accepted principles for the organisation of economic activity everywhere, including mature democracies as well as emerging markets.

The reward from globalisation in terms of higher standard of living cannot be reaped without substantial policy improvements pertaining to both corporate and democratic governance. Indeed, risk increases with the reward. If a financial crisis destroys a fragile civil society, then the combination of political and financial freedom found in mature democracies may seem unattainable by developing countries. Yet financial crises have affected emerging markets much more than aid-dependent countries. The reason is that an economy heavily dependent on official development assistance is typically unable to borrow in international financial markets. In this way, exclusion has a paradoxical insulating property. The paradox comes from the fact that the apparent risk reduction comes at the expense of the rewards foreign savings may bring to the national economy.

Nevertheless, this threat is perceived to be more pronounced in the least advanced countries than in emerging markets. Most calls for 'inclusive globalisation' come from the countries with small weight in the international system mentioned in No. 58 of *Centesimus Annus*.

Combining the gains from opening-up to the outside world with social cohesion involves, however, continued reforms, which turn out to be essential for a country to emerge: inclusive globalisation matters most for the least advanced countries, because this is where improvements in governance are least credible. As discussed in section 5 below, peer pressure may allow even the least advanced countries to earn credibility, thus contributing to the quest for inclusive globalisation.

At the national level, governance structures need to be found that can bridge the gap between the challenges of globalisation and the need to maintain social cohesion. Many countries have already been reducing state involvement in the economy through privatisation, opening up to trade and investment and deregulation, thus allowing market forces and the private sector to guide resource allocation to a much greater extent than before.

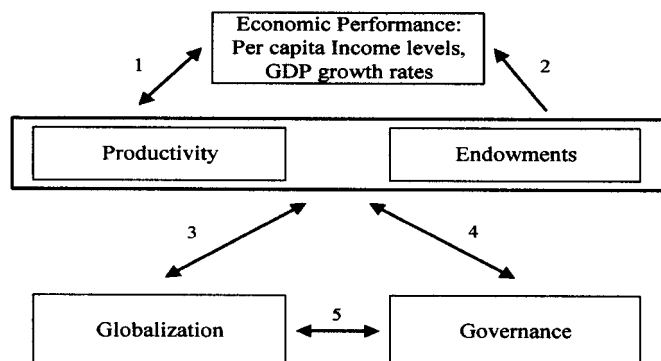


Figure 1. A map of the links between G&G and national economic performance.

Similarly, a country with a good governance, namely a democratic state with high-quality institutions, effective corruption-free accountable bureaucracies, and a flourishing civil society may likely increase the quality, if not the quantity, of its most important endowment: its own people. Once more, cause and effect can be swapped: well-endowed countries may evolve towards democratic forms of government more easily, or, at least, they may afford investing more resources to build well-functioning institutions (arrow 4, which has also attracted economists' interest, but was considered outside the mainstream until the revival of political economy evident in the 1990 Vatican colloquium and emphasised in Macedo 1992 and references therein). The G&G interaction is captured by arrow 5.

A large cross-country sample covering various statistics for the 1995-98 period and described in BBB has been used to construct Figures 2 through 4, showing the links between government size, income and openness. It should be noticed that histograms do not infer any causality between the two variables – the one used to form the groups and that measured for each group – and that very similarly looking histograms would appear in the figure if the two variables were exchanged. The choice was dictated by the convenience to have percentages on the vertical axis.

In Figure 2, the histograms on the left depicts the level of government spending as a percentage of income for different country groups. Countries are assigned to a specific group according to their level of development measured as income per capita. The clear pattern that appears here is that, moving from the 'very low' income per capita group

grammes is constrained by budget revenues and procedures and by the general macroeconomic need for maintaining or achieving internal and external balance. In poor countries that undertake trade liberalisation, lower tariff revenues are an additional constraint for social expenditure because trade liberalisation is rarely self-financing.

In short, the ability of the economy to respond flexibly to trade liberalisation, to attract and maximise the benefits of foreign investment and to benefit from globalisation is determined by the level of local human skills and the quality of democratic and corporate governance institutions.

Ironically, just as the citizens of developing countries are being encouraged to demand a voice in decisions that affect their lives, they are also being told that in the arena most central to their concerns they really have no choices. Meaningful choice is possible only with an informed citizenry and accountable policymakers. Development aid institutions now routinely say that 'the country should be in the driver's seat'. But to realise the full potential of this rhetoric, the country must know how to drive, and be able to make decisions about where to go. Aside from the activity on 'Empowering people to take advantage of globalisation', a project directed by Joe Stiglitz and Ann Florini at the Carnegie Endowment for International Peace addresses the tension between globalisation and democratisation along the lines just described.

2.3 *The G&G interaction: some stylised facts*

Figure 1 summarises links operating at national level between G&G and economic performance. The top panel shows how a nation's resource endowments and its productivity determine how fast it can grow and the level of its economic well being in terms of income per capita (arrows 1 and 2). Feedbacks are possible: a richer country growing fast may invest more resources in scientific research and technology development and thus enjoy higher productivity levels than a poorer, slow-growing economy; this explains why arrow 1 is double-sided.

The bottom panel shows that, through trade, capital flows or migration, globalisation can influence the level of endowments available in an economy, or even, through international technology transfers, its productivity. Conversely a country's endowments of natural resources, labour, and capital, as well as its geographic location and efficiency of its production structures may determine how much it trades with the rest of the world (arrows 3, which, like arrows 1, 2 have always been at the core of economic thought).

to the 'very high' one, government spending increases; in other words, richer economies on average display larger governments. Honouring a nineteenth-century German economist who first noticed it, this pattern took his name: 'Wagner's Law'.

The histogram in the centre measures government spending when countries are grouped according to their level of trade openness equal to the ratio of imports plus exports on income. Another remarkable pattern appears here: countries trading more intensively have larger governments. It seems as if countries heavily relying on global markets tend to compensate the ensuing risks they take with a bigger public sector. In fact, this is exactly the theory advanced by Dani Rodrik (1996) who constructs a model where government size provides an indirect insurance against risks originating from global markets. By employing more people or through their social safety nets, large governments partially insulate their citizens from global markets fluctuations. Although contending theories may explain the size of the public sector, the simplicity of this model is appealing and its predictions are validated by empirical tests.

The histogram on the right displays the other important relation between income and openness again. Countries are grouped according to

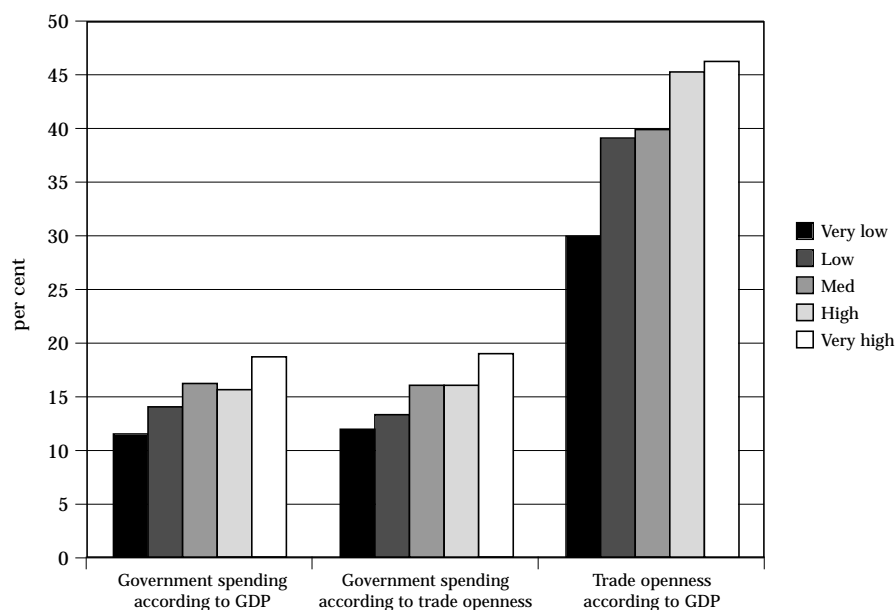


Figure 2. Government size, Income and Openness.

their level of income per capita and trade openness of the resulting five categories is measured by the height of the histograms. The figure seems to offer a neat positive answer to the question 'do more open countries grow faster?'. Yet the links between trade openness and growth are much more complex and the debate among those who support globalisation as a positive growth factor and those who are more sceptical is not settled.

The size of government expenditure is certainly a loose approximation to governance. Figure 3 employs an index of the quality of the bureaucracy and shows that richer and more open countries have higher quality administrations.

The numerical measures for corruption used as the dependent variable are indices produced for the use of international investors, and derived by standard questionnaires subjected to large random polls so that, by construction, they facilitate cross-country comparisons. In addition their commercial value partially guarantees their accuracy. Objective indices would be preferable if they were measured consistently across countries and were independent of corruption itself. Consider, for instance, a measure such as reported fraud cases: its objective value may depend on country-specific definitions and local corruption-fighting systems so that a country with a true low level of corruption and efficient

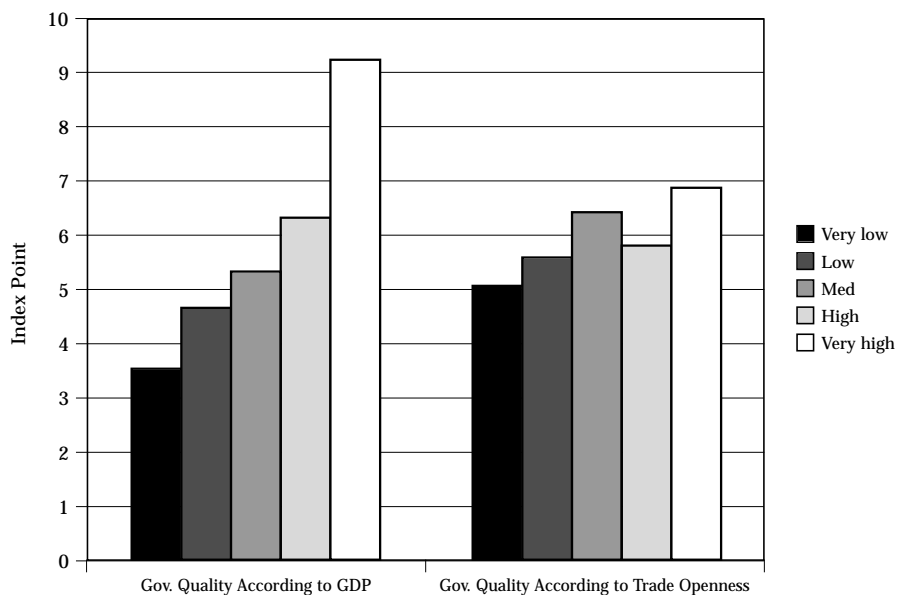


Figure 3. Government quality, Income and Openness.

monitoring schemes may report more numerous fraud cases than a more corrupt country. Corruption indices used here are those produced by TI and by the International Country Risk Guide (ICRG), rescaled so as to vary in a continuous interval between 0 and 10, where 10 reflect the lowest level for corruption.

Figure 4 groups countries according to their levels of perceived corruption (ICRG) and displays the level of import openness (the ratio of imports on income), international capital flows intensity (foreign capital flows on income), and a liberal trade policy index. The histograms suggest that countries perceived to be more corrupt are less opened to imports, have a lower degree of integration in the international financial market, but do not necessarily seem to have a less liberal trade policy, at least according to the particular trade policy index used here.

Observing the histograms in Figures 2-4, one may be tempted to conclude that richer countries, as opposed to poorer, have a tendency to be more open to international trade and to have a larger and better public sector; or, in other words, that successful economies are able to attain the right mix of market and state.

As already noticed in connection with Figure 1 above, causality is one of the fundamental problem social scientists have to face when studying the relationship between economic performance, institutions and global markets. On the one hand, many papers document how high-quality institutions foster economic growth; on the other hand, evidence is accumulating on how developed countries may afford better institutions.

Complexity is the other fundamental problem. The histograms shown above are appealing due to their simplicity: they depict patterns linking pairs of variables, however these apparent patterns may be caused by the influence of other variables. Economic development, for instance, may be at the origin of a spurious relationship between government size and openness by simultaneously increasing the levels of both of them.

Explaining how globalisation affects governance and how it helps or hinders economic development means to clearly identify causes and effects and to take into account multiple factors. To do that, section 3 moves from graphs to statistical testing. At the same time it restricts the multi-dimensional phenomenon of governance to one of its manifestations, which is perceived corruption. Clearly, there are many other dimensions of good governance besides low corruption, but the availability of these indices have made it possible to quantify this particular manifestation.

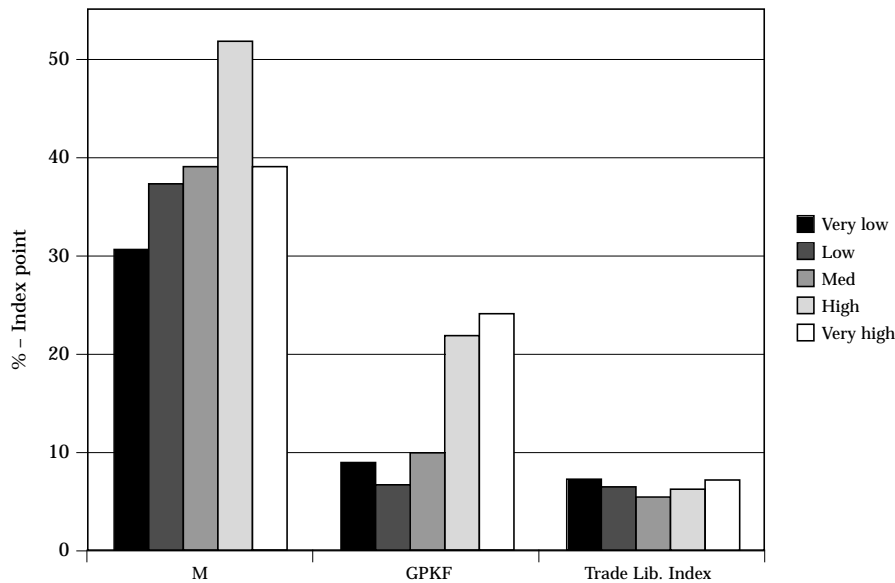


Figure 4. Imports, capital flows and trade liberalization links with perceived corruption.

Note: M is the ratio of imports to income; GPKF stand for Gross Private Capital Flows and this is also a ratio with respect to income; higher values for the trade liberalisation index correspond to more liberal trade policies.

3. GLOBALISATION AND CORRUPTION: A QUANTITATIVE APPROACH

3.1 Data

Why and by how much does openness influence the level of perceived corruption in a given country? This is the central question we attempt to answer in this section. On the surface, no relationships seem to link openness and corruption directly, and a brief digression on the theoretical determinants of corruption is useful before considering our results. Increased private gains are corruption's main objective, however, among its crucial causes, we find economic as well as cultural and social variables. Citing Robert Klitgaard (1998), corruption thrives when monopoly power is combined with discretion and low accountability. Incentives to bribery do not arise in a society where all economic activities are carried out in a perfect

competition setting and no single agent is able to affect the price or the quantity of the product he sells or buys. By the same token, corruption is reduced when economic rents do not depend on the discretionary power of some public official, or when monopolistic economic activities as well as governments are subject to strict rules of accountability.

The ICRG index of perceived corruption is available yearly for 119 countries over the periods 1984-88 and 1990-98. Instead of using yearly data, three averages corresponding to the periods 1984-89, 1990-94, and 1995-98 are used, so as to reduce data variability due to temporary shocks. Since there are no yearly estimates of all the dependent variables in all the countries, this averages approach to fill the gaps is preferable to restricting the sample: it maximises cross-country variations with little time variation sacrificed.

Following Felipe Larrain and José Tavares (2000), BBB extend the concept of openness to include capital flows as a percentage of GDP. The three theoretical mechanisms through which import openness may influence corruption (legal barriers, foreign competition, and monitoring costs) also apply to capital flows. Due to the difficulty in finding exogenous variables proxying policy input, however, the results reported here only pertain to import openness. Suitable policy variables affecting capital flows (such as corporate tax rates and relevant regulations) are not available for the same cross section of countries.

The empirical assessment takes into account potential reverse causality from corruption to relevant economic variables and uses geographical determinants as instruments to correct for this. The openness measures that may influence corruption are unaffected by it and economic policies are not influenced by corruption levels or by economic variables. The focus is on the sign and magnitude of the marginal effect of import openness on corruption but several additional explanatory variables are suggested by the theory on the causes of corruption. The level of development of a country, by influencing cultural attitudes towards corruption and by affecting the amount of resources that may be devoted to monitor public officials, is a key determinant of corruption levels. It is proxied by income per capita.

A country's score on basic political rights may be a good proxy for its degree of accountability, another important factor explaining corruption. To avoid omitted variables bias, additional social causes for corruption are introduced in the estimation. If, for instance, ethnic fractionalisation were to determine a lower level of corruption and to be strongly correlated with trade openness, but would nevertheless be omitted from the regressions,

then the positive influence attributed to openness should in reality be assigned to ethnic fractionalisation.

Economic policy variables, such as trade liberalisation or state intervention in the economy, are also tested for their possible direct effect on corruption.

Among the independent variables, openness and income may suffer from the problem of reverse causality. In principle, a corrupt bureaucracy could induce a lower degree of international integration by erecting discretionary barriers. Through excessive regulations and direct waste of resources, a corrupt bureaucracy could even hinder the development process. If not corrected, reverse causality can be a serious drawback in the estimation. It alters not only the magnitude of the coefficients but also their meaning: instead of verifying whether openness or income influence corruption, all that is being picked up is by how much corruption affect the chosen regressors. Fortunately, by identifying suitable instruments that are highly correlated with openness and income but that do not directly influence corruption, standard econometric techniques overcome this problem. So as to identify suitable instruments, new theoretically sound explanations are needed for how openness and income are determined independently of corruption.

Because the impact of geography on corruption can only result from its influence on income, the absolute value of latitude, a dummy for tropical countries and time dummies accounting for time dependent variables are used as instruments to get a valid estimate of 'corruption-independent income'.

The well-established gravity equation that links bilateral trade flows to distances from major trading partners and the size of domestic markets helps in the instrumentation of import openness. Besides geographical and size variables, cultural proximity may also explain trade intensity. Measures of remoteness, in particular, a weighted average of each country's distance from its trading partners in which the weights are given by the share of exports of the country's partners in global exports, are therefore used as regressors. According to this specification, a country's degree of 'corruption-independent openness' increases with its proximity to the largest world traders. The same happens if the country's official language is English. Conversely, the larger the size of a country's domestic market, proxied by its population, the lower its openness.

A potential problem concerns the endogeneity of import openness. Reverse causality could arise if a corrupt bureaucracy had the power to affect trade barriers directly but the measure of corruption used rules this

out. When different approaches to instrumentation of openness and income are explored, formal tests reject the hypothesis that *both* income and import openness are endogenous.

The instrumentation of import openness can also be criticised on the grounds that the instrumental variables used in the first stage regression – remoteness and size – could exert an independent effect on corruption, therefore biasing the second stage coefficients. Less remote countries are ‘naturally’ more open and need to invest more in institution building, thereby showing lower levels of perceived corruption (Shang-Jin Wei, 2000). In turn, smaller countries could find it easier to implement an efficient control on their territory. Introducing remoteness directly into the basic specification, together with a measure of size, checks against both possibilities. Since population is highly correlated to import openness, the logarithm of land area is used. Checking for the diseconomy of scale or ‘size effect’ on corruption also controls for the devolution of government functions to the regional or local level.

3.2 Analysis

The results reported in tables 1 and 2 accord with the stylised facts presented in section 2.3 above. Countries with a higher degree of import openness record, on average, lower levels of corruption. The same tendency applies, with stronger intensity, to the level of income. Results are unchanged when income is treated as endogenous. For the other exogenous variables, countries showing stronger accountability, proxied by the political rights index, lower sectoral concentration in their exports, and higher proximity to the major exporters also register low levels of corruption.

Table 1 presents the effect of import openness on perceived corruption. The specifications in columns (1) to (3) are estimated using pooled ordinary least squares (OLS). Results in column (4) come from a two-stage procedure where income per capita is instrumented using geographical variables and time dummies. Both estimation techniques show the positive impact of openness on the quality of governance, viz. a reduced level of corruption.

The regressions are in lin-log specification, meaning that the dependent variable, corruption, is in linear format and the independent variables are in logarithmic format. In this specification the coefficient can be interpreted as the marginal effect on corruption of a change in the logarithm of the dependent variable, or, as the marginal effect due to a relative (percentage) change in the dependent variable in linear format.

The most parsimonious specification – which includes only import openness, per capita GDP (both in logs) and an index of political rights – explain almost 50 per cent of the variability in the corruption index. All variables are significant at conventional levels and display the expected sign. Column (1) predicts that a 10% increase in imports openness results in 0.03-point change in the corruption score (0.34×0.1). This is a sizeable effect, especially when compared to the 0.09-point changes due to a 10% increase in log income per capita.

To isolate the direct impact of openness on governance, other simultaneous determinants of corruption must be considered. Controlling for dependence on oil and mineral exports (column 2), remoteness and size (column 3) does not change the overall picture. The first result is consistent with a vast literature pointing to higher rent-seeking behaviour in natural resource abundant countries, and with the voracity effect mentioned at the end of Section 1 above. As for the size variable, it is not significant, even after controlling for the existence of federal government structures (the specific dummy included in the regression was not significant and is not reported). Column (4) presents results obtained under the assumption of endogenous GDP. Basic findings are unchanged.

The index of trade policy liberalisation reported in Figure 4 above and the logarithm of government consumption over GDP, which imperfectly proxies the extent of government intervention, as discussed in connection with Figure 1 above, are the policy variables used in the regressions presented in columns (5) and (6). The trade liberalisation index is available for the last period only. For comparative purposes, the basic specification is re-estimated over this period. As the two policy variables are not significant and basic findings remain unchanged.

3.3 *Culture*

Recent empirical research on the causes of corruption and the quality of governments suggests that a further series of social and historical variables should be considered. In particular the role of ethnic fractionalisation, the colonial past, that of the religious traditions, and that of long-term stable democratic institutions have been seen as important explanatory variables for the level of corruption.

Table 2 adds to specification (3) of Table 1 these additional controls. Contrary to the hypothesis raised in section 3.2, ethnic fractionalisation is never significant. The effect of ethnic fractionalisation on corruption is not

Table1. Globalisation and Corruption (pooled data).

| <i>Estimation</i> | (1) | (2) | (3) | (4) | (5) | (6) |
|-------------------------|-----------------------------------|--------------|--------------|--------------|--------------|--------------|
| | OLS | OLS | OLS | IV | OLS | OLS |
| <i>Dependent Var.</i> | Perceived corruption index | | | | | |
| <i>Regressors</i> | | | | | | |
| C | -4.22 | -4.39 | 3.74 | 4.83 | 1.34 | -0.22 |
| Log (M Openness) | 0.34 | 0.36 | 0.38 | 0.34 | 0.55 | 0.51 |
| | <i>2.33</i> | <i>2.45</i> | <i>2.48</i> | <i>2.18</i> | <i>2.21</i> | <i>1.98</i> |
| Log (GDP) | 0.91 | 0.97 | 0.78 | 0.74 | 0.63 | 0.60 |
| | <i>8.53</i> | <i>9.41</i> | <i>6.49</i> | <i>2.95</i> | <i>4.59</i> | <i>4.35</i> |
| Pol.Rights | 0.19 | 0.15 | 0.14 | 0.14 | 0.20 | 0.21 |
| | <i>5.38</i> | <i>4.11</i> | <i>4.17</i> | <i>2.81</i> | <i>4.64</i> | <i>4.50</i> |
| Oil-Min Exports | | -0.87 | -0.73 | -0.70 | -0.13 | -0.25 |
| | | <i>-3.48</i> | <i>-3.03</i> | <i>-2.69</i> | <i>-0.36</i> | <i>-0.72</i> |
| Remotness | | | -0.89 | -0.94 | -0.60 | -0.49 |
| | | | <i>-4.06</i> | <i>-3.15</i> | <i>-1.89</i> | <i>-1.49</i> |
| Log(Area) | | | 0.10 | 0.10 | 0.10 | 0.11 |
| | | | <i>1.79</i> | <i>1.60</i> | <i>1.39</i> | <i>1.44</i> |
| Lib | | | | | | -0.06 |
| | | | | | | <i>-0.84</i> |
| Govsize | | | | | | 0.51 |
| | | | | | | <i>1.49</i> |
| R2 | 0.49 | 0.51 | 0.55 | 0.54 | 0.60 | 0.61 |
| Number of Obs | 305 | 305 | 305 | 305 | 103 | 103 |

t statistics are shown in italics below the estimates. Time and federalism dummies included in the OLS estimation are not reported. In column (3) Log(GDP) is instrumented by tropics, time dummies, and legal system origin. Column (5) and (6) refers to the last period only (1996-98).

clear. While recent investigations indicate high fractionalisation as a negative determinant of growth, studies focusing on the causes of corruption do not find such a clear-cut result. Roberta Gatti (1999), for instance, finds that fractionalisation is significant in reducing corruption. This finding is

explained in terms of the increased difficulties bureaucrats encounter in extracting bribes from ethnic groups they do not belong to.

'Colonial past' seems to exert a negative influence on good governance in column (3b), but it is not statistically significant. The coefficients on 'protestant' traditions, 'democracy' and 'OECD' membership, on the other hand, are significant, show the right sign and increase the R-squared of the regressions. Countries where protestant is the largest confession, where democracy has been uninterrupted for the last 50 years, and that belong to the OECD record lower levels of corruption.

The estimation of the effect of import openness on corruption is not affected by omitting these additional controls; on the contrary, with their introduction its explanatory power is actually increased. It seems that these variables, by lowering the explanatory power of the income and political rights coefficients, are in fact accounting for deep institutional and social cross-country differences.

But the interpretation of such variables should not reflect that they are all in dummy format and thereby they are really just labels used to describe a, sometimes quite loose, common characteristic of a particular group of countries. In fact the only proper label is one not usually standing for culture, namely OECD membership. This group of thirty countries adopted common measures to fight corruption and is trying to enforce them through 'peer pressure' mechanisms, as described in section 5 below. Rather than testing serious hypotheses on how, for instance, being a democracy may affect a country's corruption level, what the 'cultural dummies' do is to provide an indication that our corruption theories are still incomplete. This is why the explicit label of OECD membership is preferable to such dummies.

As the two policy variables included are not significant and as their introduction actually decreases the magnitude and statistical significance of the openness variable, some caution should be used when drawing economic policy implications. In fact, reducing trade barriers may not bring immediate positive corruption reductions. It is true that in the long run, more open economies, enjoying more foreign competition and investing abundantly in institution building, will register lower corruption levels. However, in the short run, domestic policies may be more valuable than pursuing globalisation at all costs. This may be especially important for poorer countries that face serious trade-offs between complying with international agreements and investing in basic development infrastructures such as education, health, and social security.

To conclude the presentation of the results, some qualifications should be kept in mind. First, even with respect to trade openness, a direct effect from trade policy was not found. Second, the addition of both trade liberalisation and government size weakened the results. Third, the positive G&G interaction was based on a cross-section study, and it is well known that this type of analysis has several problems. Cross-country differences in the levels of the dependent variables are the central explanation for the variations in the dependent variable, and, no matter how many controls are added, it will always be possible that some additional relevant variable is missed or wrongly measured and that results are thus distorted. It is possible to account for many local characteristics, yet comparing China to the USA, or India to Argentina, will always be a bit stretched. This is also why the next sections make comparisons by means of specific examples rather than by statistical methods.

4. CORRUPTION AND GOVERNANCE

4.1 *The role of private enterprise*

Conventional wisdom continues to associate corruption with private enterprise, rather than with state intervention. Conversely, anti-corruption continues to be seen as a matter for the state rather than a business concern. Yet the report of the Washington conference on corruption (WCC) and Macedo (2000) suggest that fighting corruption is a pro-business agenda. It is in the private sector's interest to operate in an environment of workable competition where the rule of law prevails. Moreover the fight against corruption cannot be waged by government alone, ignoring the private sector and other parts of civil society. When firms commit to refuse to engage in corrupt practices, they follow a self-regulation (or judicial) approach. Instead, the approach underlying the OECD *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, involves institutional reform, facilitated by a dialogue of the private sector with the government to work together in changing the environment and in defining new 'rules of the game'. According to both approaches, corruption is bad for business and business is bad for corruption.

The progress in institutional reform since the OECD convention was signed is evident in two new OECD publications. *No Longer Business as Usual: Fighting Bribery and Corruption* presents the process that led up to the signing

Table 2. Additional controls – historical variables.

| | (3a) | (3b) | (3c) | (3d) | (3e) |
|-------------------------|-----------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| <i>Dependent Var.</i> | Perceived corruption index | | | | |
| <i>Regressors</i> | | | | | |
| C | 2.00 | 1.97 | 3.39 | 1.64 | 0.26 |
| Log (M Openness) | 0.45 <i>2.83</i> | 0.45 <i>2.83</i> | 0.43 <i>2.54</i> | 0.41 <i>2.19</i> | 0.50 <i>2.63</i> |
| Log (GDP) | 0.92 <i>5.86</i> | 0.92 <i>5.81</i> | 0.77 <i>4.89</i> | 0.89 <i>5.11</i> | 0.70 <i>3.86</i> |
| Pol.Rights | 0.14 <i>3.70</i> | 0.14 <i>3.61</i> | 0.10 <i>2.80</i> | 0.08 <i>1.93</i> | 0.06 <i>1.42</i> |
| Oil-Min Exports | -0.72 <i>-2.69</i> | -0.72 <i>-2.67</i> | -0.78 <i>-3.06</i> | -0.82 <i>-2.98</i> | -0.76 <i>-2.81</i> |
| Remotness | -0.90 <i>-4.07</i> | -0.90 <i>-3.74</i> | -0.87 <i>-3.99</i> | -0.70 <i>-3.16</i> | -0.37 <i>-1.87</i> |
| Log(area) | 0.11 <i>1.82</i> | 0.11 <i>1.75</i> | 0.09 <i>1.45</i> | 0.00 <i>0.06</i> | -0.03 <i>-0.48</i> |
| Ethnic Fract. | 0.73 <i>1.67</i> | 0.73 <i>1.66</i> | 0.41 <i>0.89</i> | 0.76 <i>1.57</i> | 0.71 <i>1.44</i> |
| Colonial Past | | -0.01 <i>-0.05</i> | 0.10 <i>0.39</i> | 0.18 <i>0.71</i> | 0.31 <i>1.32</i> |
| Protestant | | | 1.54 <i>4.99</i> | 1.40 <i>4.36</i> | 1.31 <i>4.26</i> |
| Democracy | | | | 0.75 <i>2.82</i> | 0.65 <i>2.54</i> |
| OECD | | | | | 1.17 <i>3.44</i> |
| R² | 0.56 | 0.56 | 0.60 | 0.66 | 0.68 |
| Number of Obs | 287 | 287 | 287 | 240 | 240 |

t statistics are shown in italics below the estimates.

of the convention by 34 countries. It reviews progress in combating corruption in international business transactions since then and outlines the work that still needs to be done. *Trust in Governments: Ethics Measures in OECD Countries* reports the results of an extensive OECD survey on ethics in government service. De-centralisation of decision-making in many countries, it finds, has created a need for new mechanisms of accountability as citizens demand higher standards of efficiency and transparency. In response, public sector organisations are increasingly using methods developed within the private sector to enhance their effectiveness. The publication analyses data and current practices in OECD countries and comments on promising trends.

Corruption may benefit some firms, but it brings problems to all others. Most firms would rather operate in an environment in which rules of competition prevail and productivity growth is sustained. Therefore, they can be allies in the fight against corruption. It is therefore as erroneous to ignore private anti-corruption strategies, and to focus only on governments and NGOs as actors than to forget that the key to success remains a durable engagement on the part of political leaders.

The process which leads to the reduction of corruption includes mobilising of the population on the problem, bringing the political elite to put it on the agenda and then reforming public institutions and procedures at the various levels of government.

Business associations and firms often have greater political weight than NGOs to pressure politicians into taking corruption seriously. For example, the General Confederation of Moroccan Enterprises has set up an ethics committee, which adopted a Charter of Ethics and started negotiations with the government to reform the judicial system. In the process of public administration reform, firms have a key role to play as advisers because they know where the problems are and why. They can also participate in the monitoring process. For example, after an initial reluctance to intervene, the Philippines Chamber of Commerce, Semiconductor and Electronics Industry Federation Inc. – among others business associations – was the strongest ally in the development and execution of reform initiatives in customs. With the change of government in May 1998, the new administration was much more sensitive to the clout of the forces which had opposed the reforms undertaken. In fact, the business sector stood up to help the current customs leadership recover lost ground and to get the reform process back on track (Hors, 2001).

Nevertheless, the WCC report argues that costs and risks for firms can be strong deterrents to action, even if the outcome of such initiatives would

be highly beneficial. Within business associations, this situation can be resolved by combining commitments to fight corruption with activities that are more directly beneficial for member companies, such as providing business information and advice. The WCC report also provides examples. The West African Enterprise Network has succeeded in combining two objectives: to promote trade and investment in the region and to encourage a more favourable environment for business. Members enjoy networking opportunities, have access to information that is highly relevant for their businesses, and they benefit from training. The International Federation of Consulting Engineers has also been successful in organising business and providing international contract documents to members while, at the same time, developing good business practices.

Note that the G&G interaction creates a link between transparency and democracy, which is captured in different ways by the Amnesty International (AI) and TI. After the restoration of political and financial freedom, an anti-corruption momentum becomes possible; but the quest for transparency has nothing automatic. It is not enough to draw the attention of aid agencies and policymakers to the potential alliances which can be made with private enterprise because business associations are not mobilised in all countries. In some cases, existing business associations do not wish to get involved in the fight against corruption. On the other hand, all successful experiences of reform seem to have required the support and the participation of the private sector at some point. For example, it is said that *Mani Pulite* was supported by Italian firms facing competition from European neighbours. Opening up to European competition forced the change of their position. Hence the question: when do different forces in the population, including private enterprise, start to take a stand against corruption? The answer should certainly take into account that, due to the forces of globalisation, the nature of the international system changed greatly and now reflects the 'new politics of credibility' stressed above.

4.2 Argentina from amnesty to transparency, via financial freedom

The link between democracy and transparency on the one side and of political and financial freedom on the other illustrate the little attention given to democratic governance in development, discussed in section 2.2 above. As a case study, consider the trajectory followed by Argentina during the thirty years before parliament voted a bill ending the impunity of lawmakers, judges and government ministers from prosecution.

Argentina got there in three steps, each taking about a decade. The elections of October 1983 mark the restoration of democratic institutions. Political freedom was not enough to bring about a sustained reduction of corruption, and more generally greater accountability of the elected team and its administration. Political institutions were in place but corruption was not a concern of the population between 1983 and 1990.

Until the 1991 Convertibility Law managed to bring hyperinflation under control, people were worried about financial stability. Then corruption did become the most or second most important problem quoted in the Gallup polls held at the time. These polls are quoted in *El desafío de la ley* by Moreno, who came from the fight for human rights and saw corruption as another form of abuse of power. Hence, when citizens enjoy both political and financial freedom, they are more likely to mobilize against practices of mismanagement and corruption.

Access to information is so important to fight corruption that simple tools, like the publication of price comparison numbers, can be a strong catalyst for change. Accordingly, a strategy based on the provision of hard data, rather than of personal accusations, appears to be very powerful. Moreno mentioned the example of Buenos Aires hospitals asked to give information on the prices that they were paying for a number of homogeneous and basic products, such as dextrose. Their information revealed unjustifiable price differences for the same product, quantity, provider and times of payment. After the publication of these comparisons, hospitals started buying more efficiently.

Once the broader macro conditions were right, and with help from USAID, civil society played an important role in bringing forward the anti-corruption agenda in Argentina, in particular experience *Poder Ciudadano* (PC). If international institutions and even governments widely acknowledge now the importance and impact of NGOs in this field and generally welcome civil society's involvement, little research has actually been conducted with regard to the effectiveness of these organisations.

PC is recognised as one of the most – if not the most- innovative and efficient chapter of TI. It also predates TI by 4 years, since it was founded in 1989, to support the democratisation process and, in particular, to fight corruption. Since 1995 PC serves as the local chapter of TI.

Almost a decade after its foundation, the three candidates to the Presidency recognised the role of PC and asked this movement to monitor the financing of campaign expenditures. At a time when the new government of Argentina starts a substantial programme to curb corruption, it is thus interesting to take stock of PC's experience. Hors has claimed

that, through innovative modes of intervention, this organisation contributed to mobilise the population on the problem of corruption and to bring the political elite to put the problem in the public agenda. This contributed to make democratic institutions work.

In addition, she claims that PC could direct its actions to better adapt to the third phase of action and of reform of public institutions. Political and financial freedom, together with the pressure of globalisation, expose corruption more crudely, but they also make the fiscal losses for the State and the costs corruption represents for firms facing external competition harder to bear. Once the broader conditions are there, NGOs can play a crucial role in catalysing an anti-corruption momentum.

The Argentine case confirms that establishing democratic institutions and the freedom of speech is necessary but not sufficient. Decisions taken in the economic sphere such as liberalisation of trade, reform of the exchange rate system are also needed to transform the situation, and get a country on a virtuous path. The interaction between political and financial freedom was used to interpret the long term evolution of the Portuguese economy.

It turns out that the role of external pressure stressed in Section 1 above for the last few decades applied in much earlier times, but then in the form of innovative tax responses to threats of war. Unfortunately, the instances of successful government responses, even after the suspension of convertibility in 1796, were forgotten and led to monetary myths which were upheld until very recently, undermining the ability of the people to adjust to financial freedom (Macedo, Silva and Sousa 2001). The issue of myths is taken up again in the conclusion.

Hors also claims that comparing the trajectories of different Latin American countries may help better to integrate the development dimension with the fight against corruption. Such comparison exercise would allow a better understanding of which conditions are necessary to ensure the successful implementation of the tools and strategies developed by TILAC and its national chapters.

TI is currently promoting the programme *Transparent Contracts* (TC) in Argentina, Colombia, Panama and other countries. The underlying general idea is to create *communities of interest*. In developed countries, the legal systems reflect a basic agreement among community members to adopt a certain set of rules, the 'social contract'. In these contexts, communities are based territorially, making up what are nation states. Today, many communities extend beyond nation-states, making it necessary to develop new concepts of social contracts. Through communities of inter-

est, NGOs serve to bring together the competing firms, the public bidders and the future consumers or users of the goods or services delivered by the winner to control for the respect of fair rules of competition.

This programme has been implemented in different ways. PC has been developing public hearings to discuss tender conditions with governments, opposition parties, companies interested in the business and citizen concerned. In Panama, the TI chapter was a neutral observer in each of the meetings held for the privatisation of the national phone company. TI Colombia is currently supervising more than 50 public procurement contracts. In some of these experiences, the programme brings firms competing on a public bid to sign an *Integrity Pact* (another name for the TC programme) that allows for mutual monitoring: firms commit to grant each other access to all relevant information so that the tendering outcome can be controlled.

The use of internet is a promising tool to control public bids, and could help support the TC programmes. In Mexico, Chile and Canada, internet sites display information regarding the bidding procedure and results. It is an important tool which enables the citizenship to control public spending and monitor the use of funds.

In Latin American countries, where foreign companies play a substantial role, the efficient enforcement of the OECD *Bribery Convention* is a crucial element for the success of the anti-corruption momentum. In Argentina for example, foreign companies hold almost 60% of the shares of consortia of privatised companies. TI has made a first contribution through the publication of a 'Bribe Payers Index' in 1999. There is certainly room for a more active participation of local chapters.

Transparency is not sustainable in the long run without political and financial freedom but the sequence may differ from the one offered by Argentina. The United Arab Emirates started to address the problem of corruption in parts of the public administration in the framework of a broader approach under the banner of ethics and efficiency. On the other hand, Taiwan and Korea enjoyed a fairly low level of corruption and rapid growth under non-democratic regimes. Both countries 'discovered in the late 1980s that repression of rising demands for democracy and free expression would be expensive in terms of their reputation and soft power. By beginning to democratise then, they have strengthened their capacity – as compared, for instance, with Indonesia – to cope with economic crisis' (Keohane and Nye 1999, p.212, the role of peer pressure in Korea is stressed by Macedo, 2001b).

5. THE QUEST FOR INCLUSIVE GLOBALISATION: A 'EUROCENTRIC' PERSPECTIVE

5.1 *Peer pressure and yardstick competition*

Even in the days of the Washington consensus, most economists and policymakers would count on effective states as well as on efficient markets to be crucial ingredients for development. When markets become more efficient states need to become more effective. This is especially important because world financial markets, by themselves, were not capable of promoting rules of good conduct among sovereign states.

The IMF and the World Bank did play a role in spreading the results of alternative policy paths among their member states, thereby reinforcing the notion that some paths worked better than others. The wide acceptance observed suggests that national policymakers stabilised, liberalised and privatised the economy in part because they saw other policymakers do the same. Within the EU, in particular, this peer pressure led to the 1992 Treaty mentioned at the outset, which has included a multilateral surveillance framework (MSF) designed to support the introduction of a single currency. The MSF has been progressively reinforced in the two revisions of the treaty.

The issue of whether peer pressure bring about improved performance has been addressed by Tim Besley and Anne Case (1995) in the context of 'yardstick competition', a term coming from industrial organisation which suggests comparing similar regulated firms with each other (Schleifer, 1985). For any given firm, the regulator uses the costs of comparable firms to infer a firm's attainable cost level. This may not fully overcome moral hazard problems, but it is certainly preferable to the traditional procedure of comparing current and future costs to past performance. The peer pressure scheme is thus susceptible to manipulation by participating firms but the difficulty in co-operating to impose collusive behaviour makes this perverse outcome less likely. Note also that in the case where heterogeneity is observable and can therefore be corrected for, Andrei Schleifer (1985) shows that a regulatory scheme based on peer pressure should lead to a superior performance.

This implies that the regulator can credibly threaten to make inefficient firms lose money and cost reduction can therefore be enforced. When national objectives are at stake, best practices can thus be achieved, rather than allowing a convergence towards the mean. Conversely, when peer pressure is used to stall reforms, rather than to promote them, the outcome is equivalent to the collusive equilibrium and an alternative yardstick must be devised.

Therefore, adapting the same reasoning, when there is peer pressure among national policymakers to follow best practices, these are likely to become more and more accepted. Peer reviews have enhanced competition for better macroeconomic and trade policies among OECD members. Similar benchmarking has begun with respect to structural policies, especially those relating to the regulatory framework. The greater complexity of such policies makes them more susceptible to procrastination, and the same problem has been observed in the EU, as discussed in section 5.4 below. This hinders institutional change and makes corporate and political governance more difficult.

Among the G-7, only the four European states have attempted to deal explicitly with their regional architecture, so that the presidents of the European commission (EC), central bank (ECB) and council (especially the EcoFin) attend the meetings. There is no sovereign national centre equivalent to that of the United States, Japan or Canada (let alone Russia, set to become the 8th member), even though the complexity of the current EU institutional framework leaves substantial room for manoeuvre to the United Kingdom and to the three large members of the eurosystem.

The question of external representation of the EU has been a source of controversy at least since its creation. Due to the fact that the EC participates in the discussions of the G-7 since 1977, the four EU (three eurozone) members tend to ignore their eleven (eight) 'peers' when global affairs are on the agenda. The same applies to the OECD, where the EC also participates. At the IMF, like in the G-7, a representative of the ECB addresses all matters directly pertaining to monetary policy.

The ambiguity of the solutions reflects, once again, the complexity of the EU institutional framework. Nevertheless, the strengths of the perspective can be put to good use in the global arena, as long as the European identity is understood as a flexible partnership portable to other groups of nations. The creation of a single currency among most members based on a MSF supported by all, helps to make the case for flexible integration in section 5.3 below.

The MSF developed among EU nation-states can be adapted to build a global financial architecture resilient to financial crises. To begin with, its intercontinental domain reflects longstanding cultural and commercial ties. Moreover, the EU probes into budgetary procedures and corporate governance standards, in ways that may offend national sovereignty if applied to Washington or Tokyo. In the OECD peer reviews and in the standards agreed upon at the BIS, unanimity is required so that national sov-

ereignty is entirely preserved. The role of the Commission as regulator and that of the Court of Justice help bring procedures closer to a regulatory framework allowing for yardstick competition.

The EU MSF does not focus on balance of payments adjustment, but rather attempt to bring together principles of good government commonly accepted and which indeed are jointly transferred to Community institutions. The degrees of commitment to the EU and to each one of its main institutions have been changing in various issue areas, as a partial response to a more turbulent global and regional environment. The creation of the eurosystem in January 1999 was followed by a difficult institutional period, which has also delayed the accession calendar. The delay reflects the propensity to procrastinate on structural reforms, rather than the recurrent European debate about whether multiple-speed convergence towards union objectives is possible and desirable.

5.2 Convergence and cohesion as common good

The current international system calls for a more effective regional and global response to threats of contagion of national crises. American national interest in preserving world stability is one such response. Co-ordination mechanisms among monetary and fiscal authorities like the ones found in the EU and in the eurozone rely on economic and societal values shared among sovereign states are another response.

The American and European interests have been complementary on many occasions and indeed originated fifty years ago in the process of allocating Marshall aid through the European Payments Union and the Organisation of European Economic Co-operation, which later became the OECD. The current relevance of these distant origins is described by Barry Eichengreen and Macedo (2001). Fred Bergsten (2000) provides a list of similarities and differences between European and Asian integration, and concludes that the former are beginning to outweigh the latter.

Under globalisation, a single country, no matter how dominant, cannot provide the 'common global good' (No. 58 of *Centesimus Annus*). The global applicability of the European experience to the search for the 'common good' suggests itself because it hinges on the 'centre' in Europe not being a nation-state, but rather a community thereof. Note that, in spite of a similar emphasis on co-operation and development, Smith and Naím 2000 hardly mention the European experience. Even in the European context, external pressure remains powerful. This is another way of underscoring

the result in section 3 above that globalisation improves governance.

The lessons from the crises in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) may be helpful in emerging markets. Basically, the largely unwritten ERM code of conduct implied a more effective co-ordination mechanism among monetary and fiscal authorities than expected. Non-compliance with the ERM code of conduct played a major role in the development of the currency turmoil, but after August 2, 1993 the EMS regained stability, thanks to the widening of the fluctuation bands, which limited speculative pressure by eliminating one-way bets and reintroducing two-way risks. The option to float in order to fix, a kind of financial 'cruel to be kind' (Macedo, 2001a) shows that the set of principles, rules and code of conduct which underlie the monetary union in stage two have proven correct for the euro as well.

The adaptation of the ERM code of conduct to improving international financial architecture would also support the creation of new networks including major emerging markets, as long as they manage to enforce financial stability. This applies to the Financial Stability Forum and to the G-20, for example.

Enforcing financial stability can lead to a virtuous cycle, whereby currency stability delivered by monetary union feeds back to a more employment-friendly economic environment. Conversely, when terminal conditions lack credibility, a 'stop-go' convergence process that hinders change may appear. Temporary, unaccountable shifts in sentiment in financial markets thus may disrupt the convergence process permanently. A government can only protect itself from this threat by acquiring a reputation for subordinating other goals of economic policy to the pursuit of convergence.

The MSF can play a role in providing timely information on national economic policies in a way that enhances the reputations of deserving governments. The same is true of the adoption of appropriate budgetary procedures at national and union levels.

Thanks to its code of conduct, the ERM acted as an instrument of convergence towards the single currency. The code was partly unwritten, but it encompassed instruments specified in the 1992 EU Treaty. These were essentially a timetable with three stages, the convergence programmes and the specific procedures included in the MSF, especially the ones dealing with excessive deficits. In addition, progress towards independence of national central banks was impressive during stage two of monetary union, as was the fact that the public sector could no longer be financed by central banks or by privileged access to financial institutions.

The European Monetary Institute was established at the end of stage one of monetary union in order to contribute to the realisation of the conditions necessary for the transition to stage three. The fact that it was delayed from 1997 until 1999 may actually have helped prevent an excessively fast politicisation of monetary policy. The politicisation would increase the temptation to soften the excessive deficit procedure, raising fears that some governments will expect to be bailed out by the union, in contradiction to Article 103 of the Rome Treaty (in its 1999 version). The approval in 1996 of the Stability and Growth Pact (SGP) also contributed to allay such fears because it actually tightened the excessive deficit procedure included in the 1992 EU Treaty. The creation of the ECB at the end of stage two of monetary union proceeded on schedule, in spite of a political dispute about the term of the initial governor.

Once again, an effective MSF, supported by all member states, was decisive for medium term policy credibility at national and union level. Indeed, all of these instruments and procedures effectively delivered convergence and cohesion. Together with political stability or social consensus and national cohesion, the MSF delivered convergence. Social consensus implies, first and foremost, that social partners and public opinion understand and accept the medium term stance of economic policy. In particular, trade unions must recognise the perverse interaction between price and wage increases, which hurts the poor and unemployed disproportionately. With the feedback of wages into prices in operation, price stability will not be durable without wage moderation. The social acceptance of these norms can be turned into a factor of national cohesion if the government takes the leadership in wage negotiations for the public sector employees.

A single market with a single currency reflects a particular combination of private and public goods, determined by the mobility of the tax base and the availability of inter-regional or inter-national transfers. Article 2 of the EU Treaty in its 1999 version refers to 'the strengthening of economic and social cohesion' as instruments of 'economic and social progress which is balanced and sustainable'. Therefore, some income redistribution among nation states is supposed to correct the economic geography that market integration brought about. As this should not be a pretext for creating an additional burden on enterprises, the structural funds directed to member states have been made conditional on appropriate policies.

Such conditionality turned out to be difficult to agree upon at the Maastricht European Council, and accordingly cohesion countries were reluctant about the proposals for flexible integration made during the

preparation for the 1996 revision of the treaty. This reluctance has been overcome, as discussed next. But it reinforces the perception that poorer member countries are more favourable than richer ones towards political integration along sheer income redistribution lines. Such perception is not only detrimental to cohesion, it also feeds the fears of a future European 'superstate' where taxation would be excessive because of international redistribution, an extremely unlikely scenario.

Where local financial monopolies exist, differences between interest rates at the core and at the periphery may endure, even in the presence of full currency convertibility and perfect capital mobility among core markets. Belonging to the convertibility and stability club is nevertheless useful to the extent it signals to market participants that the country is keen on achieving external credibility without relying only on instruments it could control – and might therefore manipulate.

A converging country is attempting to buy domestic credibility for its efforts. This is the only way in which the national authorities could escape the adverse selection bias from which new participants in the international capital market have been shown to suffer. One reason why the instruments and procedures underlying the ERM code of conduct delivered convergence and cohesion certainly is the 'new politics of credibility' of Keohane and Nye (1999) but another is the quest for the 'common European good'. The notion of medium term policy credibility emerges as essential in the evaluation of the EU MSF. Both the credible MSF and this form of inclusive globalisation on a European scale are consistent with flexible integration schemes, described in the next section.

Now the European System of Central Banks (ESCB) provides price stability in the eurozone by means of a single monetary policy but the institutional framework of the eurosystem draws on the functioning of the EMS based on a common (now single) monetary policy and on national fiscal policies. The single monetary policy is conducted by the ESCB led by the ECB and independent of national governments and of the EC. The national fiscal policies are co-ordinated by multilateral surveillance procedures. These include the SGP; they are monitored by the Euro Group (which gathers the Ecofin Council members from the eurosystem) and by the EcoFin Council itself.

Yet the ESCB, the Euro Group and the SGP together do not quite match the 'rules of good housekeeping' of the gold standard because some features of the articulation between the single monetary policy and national fiscal policies remain ambiguous. Is the ESCB accountable to the European par-

liament, national parliaments, both or neither? Who is responsible for exchange rate policy? No matter how crucial, these aspects are not alone responsible for the observed weakness of the euro relative to the dollar and the yen. Difficulties in making the institutional architecture more flexible and the (related) propensity of governments to procrastinate on unpopular reforms are also to blame. They are taken in turn in sections 5.3 and 5.4.

5.3 *The case for flexible integration*

The recurrent European debate about multiple-speed convergence helps illustrate the complementarity between global and regional common good. One extreme position in the European debate draws on the view of a unified constitutional state, for which variable geometry is impossible. The other extreme position calls for a set of contractual arrangements, where common institutions are undesirable.

From the beginning, the European Community attempted to transcend the rigid intergovernmental nature of the OECD or of the G-7 (which does not even have a permanent secretariat) in the direction of supranational institutions like the EC. But the convergence stopped far short of establishing Community-wide democratic legitimacy. As a consequence, the institutional framework became more and more complex, especially after a Union with three pillars (the Community and two intergovernmental ones) was created in the 1992 EU Treaty. In the process, flexibility was lost and this is why the debate about multiple-speed convergence towards union objectives has resurfaced. Another reason is, of course, the imminent enlargement.

For any given number of member states, there is a trade-off between the freedom to enter into contractual agreements which include some members and exclude others and the ultimate requirement of 'one man, one vote' which would be associated with a new state emerging from the integration of all members. In Figure 5, adapted from CEPR (1996, p. 47), the vertical axis measures flexibility and the horizontal axis measures depth of integration. The origin represents purely intergovernmental co-operation among the same member states. The vertical axis represents economic efficiency and executive performance, or the forces of competition, while the horizontal axis represents legal status and legislative activity, or the forces of co-operation. Each point in the quadrant can therefore be seen as a combination between competition and co-operation.

The highest point on the vertical axis, labelled 'à la carte', would be equivalent to a purely contractual institutional design where any combina-

tion of subgroups of member states is acceptable, so that the basic inter-governmental principle of equality of member states applies and unanimity in decision making is preserved. During the revisions of the Union treaty in 1996 and 2000, intergovernmental schemes of 'reinforced co-operation' have been called for among some member states, as their creation still requires unanimity of all member states and their membership is open to all of the member states who qualify.

These manifestations of flexible integration are consistent with the operation of the principle of proximity (or subsidiarity) mentioned at the outset, according to which further decentralisation is acceptable and desirable. Indeed, CEPR (1986, p. 65) mentions a generalised subsidiarity principle, where decentralisation can go towards groups of states, rather than local and regional bodies within each state.

The horizontal axis would go to the extreme where majority voting applies to the voting population without regard to its national location, labelled 'superstate'. There co-operation among the (former) member states would cease to be relevant politically, economically or socially. Quite clearly, even in areas where single policies have existed for a long time, such as tariffs, and the EC has an undisputed mandate, the relevance of the member states is always there. The same can be said about monetary policy, administered by the eurosystem.

With respect to the objective of a free movement of persons, it was achieved properly for the first time on 19 March 1995 by the seven member states (Belgium, France, Germany, Luxembourg, the Netherlands, Portugal and Spain) that are parties to the Schengen convention. When the EU Treaty modified at the Amsterdam European Council came into force on 1 May, 1999, the freedom of movement was extended to all others, with the exception of the United Kingdom and Ireland.

Not all combinations of flexibility and integration defined by the two axes are possible, let alone desirable. In effect, for each specific issue-area, when integration becomes deeper, purely contractual arrangements are constrained and when the principle of equality between members is sacrificed to the democratic deficit, flexibility is constrained. Therefore a downward sloping line can be defined between the point of maximum flexibility and no common institutions and the point to the right of which deeper integration would prevent any flexibility in the co-operation among member states. The intersection should be to the left of the point labelled 'superstate'.

It is assumed that along the 45 degree line, there is a balance between integration and flexibility. This means that flexible integration schemes

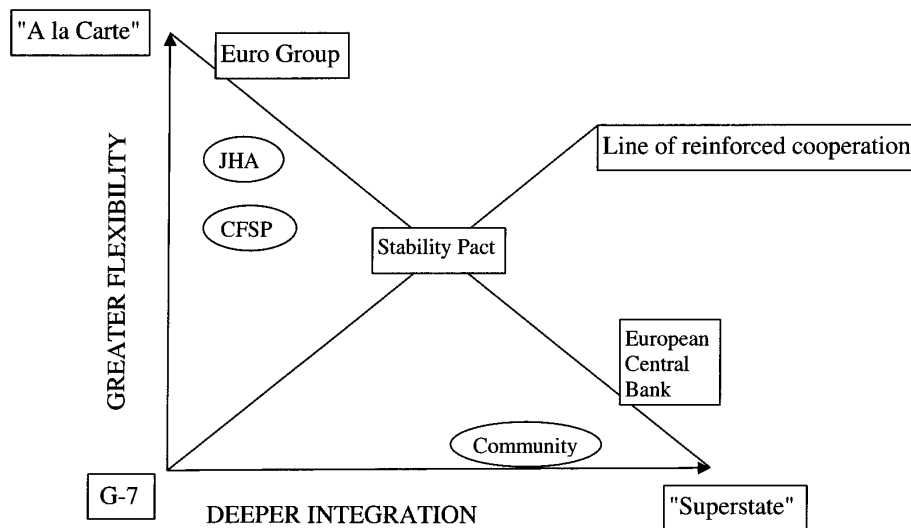


Figure 5. European institutional architecture.

along this line will balance the contractual commitment and the deeper integration, as called for by schemes of 'reinforced co-operation' mentioned above. If the combinations of a common base and open partnerships defined in functional rather than geographical terms (CEPR, 1996, p. 59) were along this line, they would balance integration and flexibility in the best possible way, given the number of states involved.

The creation of the EU called for new institutions such as the ESCB while the excessive deficit procedure regulated the surveillance in the area of budgetary policy required for a sustained operation of the eurosystème. Increased intergovernmental co-operation common foreign and security policy (CFSP) and justice home affairs (JHA), the latter in conjunction with the free movement of people and the creation of a common asylum and immigration policy. These institutional procedures have been put in place gradually but this has not overcome the fact that the architecture resulted from last-minute negotiations at the European Council in Maastricht rather than from an explicit commitment to flexible integration.

As shown in Figure 5, the array of open partnerships provided by the two pillars complements the Community, as a very significant base including all members, but the areas of interaction are limited. In the economic and financial area, on the contrary, the ECB and the Euro Group are com-

plemented by the SGP. In all three set-ups, but especially in the SGP, countries not in the eurosystem follow the rules anyway. Moreover Denmark continues to follow the ERM code of conduct.

In any event, the resulting institutional framework is extremely complex with areas of duplication and inefficiency alongside areas where resources are insufficient. This applies to the various secretariats but also to the Commission itself which has been involved over some years in a difficult internal restructuring. Whatever the place of the entire Community architecture in Figure 5, the combination of the three pillars is unlikely to be along the diagonal. Probably a legalistic approach would place the union architecture more towards the Community than towards the intergovernmental pillars. While the common base remains difficult to distinguish from open partnerships nearly ten years after the EU Treaty was negotiated, with the revisions agreed at the European Councils in Amsterdam and Nice, there is a suspicion that the balance has tilted towards the vertical axis, but so far without noticeable improvements in executive performance.

Since all member states have met the entry criteria for monetary union (independently of the willingness to join for Sweden and the United Kingdom, and the membership of Denmark in the ERM), the case for flexible integration has been strengthened by the euro and there is greater acceptance that variable geometry was inevitable in the case of a single currency. Jacquet and Pisani-Ferry (2000) note in closing that the Nice Treaty provides the possibility of making use of 'reinforced co-operation' in the field of economic and monetary union.

In sum, the flexibility approach to European integration stresses the portability of the European experience to countries in different stages of economic and financial development. As such it may facilitate enlargement. But it also helps improving the EU institutional framework, especially its financial architecture, now that the stability culture prevails among its 15 members.

5.4 *The danger of procrastination*

The notion of medium term policy credibility emerged as essential in the evaluation of how the regime in the EU Treaty combined convergence and cohesion. This credibility hinged on the functioning of the SME. It now depends on the institutional framework of the eurosystem, which is based on a single monetary policy and on national fiscal policies.

The lack of credibility of the 'common European good' in world financial markets reflects the absence of reforms in member states. If the propensity

to procrastinate is reversed, a European identity might appear even in areas of reinforced co-operation among some member states, such as money and finance, let alone development and even migration. This combination of global unity with regional and national diversity would certainly increase the portability of EU procedures in transition and emerging markets.

Unfortunately, national governments have used the euro as an excuse for procrastinating on unpopular but essential structural reforms. Yet, even if the euro-based MSF is effective, it cannot replace reform in labour markets, social security, education and training etc. Only if reforms take place will medium term credibility be ensured so that replacing national currencies with the euro will have effects according to the credit ratings of nations, cities and firms rather than their geographical location. Indeed if countries use monetary union to procrastinate on their unpopular reforms, the benefits of the stability culture may vanish both at the core and at the peripheries. The 'hold up' problem in the industrial organisation literature suggests the similar danger of a 'euro hold up' (Macedo, 1999).

Traditionally, system stability has been provided by the largest national economy. The provision of the international public good is made in ways that are often determined by national traditions and institutions. The provision of the international public good is also in the national interest, which in this case is often represented by institutions sensitive to the needs of the taxpayer and therefore more prone to understand and fight against the incentive of each one of the member countries to free ride. As there is no dominant player in the EU, procedures relying on an agreed MSF, had to be devised and implemented.

The incentive to free ride on the public good is indeed greater for the small countries but without a decision to join which can be domestically supported, the benefits of convertibility and stability are also less apparent.

The public good element of the euro cannot be achieved against market sentiment, but policy credibility can overcome hierarchy. Any solution not based on the national cohesion of the member states would be unstable. No member-state is likely to remain in a slower speed of convergence against its national interest, expressed by majority vote. National and union cohesion thus became requirements for the competitiveness of European business world-wide.

In other words, the euro is largely an enabling reform that requires additional structural adjustment. If carried out by the EU states, structural reforms would not only enhance the potential of the euro as a world currency but also the competitiveness of European firms. The role of the EU

notwithstanding, the institutions of global economic and financial governance have, in one way or another, helped prevent the 1997-99 financial crisis in emerging markets from becoming a 1930's style global depression. This is true in spite of the spectacular interruption of the Millennium Round of the WTO launched in Seattle in late 1999 and of subsequent protests at meetings of the Bretton-Woods institutions. While it is essential to empower people to face the challenges of globalisation, the changes in governance that are called for cannot become protectionist without threaten the basic benefits of open trade in goods, services and assets and of the fringing movement of people.

6. CONCLUSION

This paper analysed some dimensions of the G&G interaction involving corruption and, more broadly, the quality of domestic institutions. In the long run, more open economies, enjoying more foreign competition and investing abundantly in institution building, were found to register lower corruption levels. While, in the short run, domestic policies may be more valuable than pursuing globalisation at all costs, the role of external pressure was shown to be powerful in specific cases, particularly in connection with European integration. The ERM code of conduct was shown to provide a regional common good, which – if portable – might support institutional change capable of better facing the challenge of globalisation in developing countries.

In spite of the code of conduct, myths from a misperceived historical experience may still interact perversely with geography. The fact that the reputation of a state in the peripheries of international currency standards may differ from that of a state in the core basically reflects the role of politics. In effect, the interaction between the commercial interests of the middle classes and the diplomatic aspirations of the central banks was already political during the gold standard. With the euro, this interaction remains political and determines whether reforms are enduring, so that employment-generating growth can be stronger. The record so far has been mixed, due to the propensity to procrastinate of many eurozone governments, leading to the threat of a 'euro holdup'.

The account of the European experience is only one example of direct ways in which national governance may be improved, namely belonging to regional arrangements based on peer pressure. Clearly, these are many specific institutional improvements called for by development which are not

covered here, and where portability to a development context has to be investigated. This investigation may be especially important for poorer countries that may face serious trade-offs between complying with international agreements and investing in basic development infrastructures such as education, health, and social security. Without the required improvements in national governance, what Macedo (1992) called the 'orderly city' (based on the etymology of political economy) cannot emerge and bring about the positive G&G interaction.

Nevertheless, I believe that the perspective of hope underlying this paper will be vindicated by future research relying on better data, sounder analysis and a finer treatment of culture. As *Centesimus Annus* implied, and Pope John Paul II emphasised on 27 April 2001, 'it is the universal common good which demands that control mechanisms should accompany the inherent logic of the market'. Development is, after all, an essential dimension of the human experience.

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