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Economically Benevolent Dictators: Lessons for Developing Democracies

Ronald J. Gilson[*] & Curtis J. Milhaupt[**]

Abstract

The post-war experience of developing countries leads to two depressing conclusions: only a small number of countries have successfully developed; and development theory has not produced development. In this article we examine one critical fact that might provide insights into the development conundrum: Some autocratic regimes have fundamentally transformed their economies, despite serious deficiencies along a range of other dimensions. Our aim is to understand how growth came about in these regimes, and whether emerging democracies might learn something important from these experiences.

Our thesis is that in these economically successful countries, the authoritarian regime managed a critical juncture in the country's development--entry into global commerce by the transition from small-scale, relational exchange, to exchange where performance is supported by government action, whether based on the potential for formal third party enforcement or by the threat of informal government sanctions. Compared to a weak democracy, a growth-favoring dictator may have an advantage in overcoming political economy obstacles to credibly committing that rent seeking will not dissipate private investment.

We explore this hypothesis by examining the successful development experiences of three countries in the late twentieth century: Chile under Augusto Pinochet; South Korea under Park Chung-Hee; and China under Deng Xiaoping and his successors. Although the macroeconomic policies and institutional strategies of the three countries differed significantly, each ruler found ways to credibly commit his regime to growth. Decades of law reform activity by the World Bank, IMF, and other international organizations, along with a vast academic literature, assume that an impartial judiciary

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is the key to the transition from relational to market exchange. Our study reveals that a variety of alternatives are possible.

We then consider a now familiar question raised about contemporary China: Does economic development inexorably lead to political liberalization? The conventional wisdom says yes, drawing support from the experience of Chile and South Korea. We show that the conventional wisdom overlooks important features of the Chilean and Korean historical experiences that bear directly on China. The same incentive structures that have propelled Chinese economic growth are likely to slow political liberalization.

The post-war experience of developing countries leads to two depressing conclusions. First, only a relatively small number of countries have successfully developed. The second depressing conclusion follows directly from the first. Development theory, in all of its evolving iterations, does not seem to work in the most fundamental way: it has not resulted in development.[1]

In this article, we respond to this discouraging result by approaching the problem from a different direction. We will work backwards from the facts to see if a pattern emerges that might provide insights into the development puzzle. We recognize that this methodology runs the serious risk of reducing to a tautology: what worked defines what should work. To avoid this result, or to at least make our process transparent if we make mistakes or succumb to the lure of a neat result, we will focus on one critical fact: to a striking degree in recent decades, some autocratic regimes have managed, despite their serious failings in other areas, to develop (indeed fundamentally transform) their economies. Our thesis is that in these successful countries, an autocratic regime has

[1] William Easterly, The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics (2001). See Jessica Cohen & William Eastrerly, Introduction: Thinking Big versus Thinking Small, in What Works in Development? Thinking Boig and Thinking Small 3 (J.Cohen & W. Easterly eds. 2009) (canvassing failures of prior academic and policy efforts.).

managed a critical juncture in the country's economic development – the economy's entry into global commerce by the transition from relational exchanges to exchange where performance is supported by government action, whether based on the potential for third-party enforcement or by the threat of informal sanctions imposed by the government.[2] We characterize these regimes as "economically benevolent" autocracies. By this term we mean an autocratic regime whose leaders' utility functions rank long-term growth in GDP more highly than growth in their Swiss bank accounts, and thus use the power of the state to pursue national economic transformation. This designation is not meant as a term of praise, but rather as a way of distinguishing authoritarian rulers who place national development ahead of personal enrichment. Put in Paul Romer's terms, the dictator has a taste for "nonexcludable goods," those that create wealth for everyone, as opposed to "excludable goods," those that benefit only the regime's leaders.[3] In this respect, our approach differs strikingly from the existing literature, which "assumes that all rulers are driven by private objectives… ."[4]

We recognize that saying something favorable about autocracy will (and should) generate an initially visceral negative reaction. Those leaders of the regimes we will describe as economically benevolent very often were not benevolent – indeed, in some

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[2] The importance of this transition has been widely recognized. See, e.g., Doulgass C. North, Institutions, Institutional Change and Economic Performance (1990); Avinash Dixit, Lawlessness and Economics: Alternative Modes of Governance (2004); Michael Trebilcock & Jing Leng, The Role of Formal Contract Law and Enforcement in Economic Development, 92 Va. L. Rev. 1517 (2006); Ronald J. Gilson, Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange, 60 Stan. L. Rev. 633 (2007).

[3] See Paul M. Romer, Endogenous Technological Change, 98 J. Pol. Econ. S71 (1990).

[4] Avinash K. Dixit, Democracy, Autocracy and Bureaucracy, 1 J. Globalization & Democ. at 9 (2010). Of course, the autocrat also may be maximizing non-pecuniary private benefits in pursuing growth, for example, being known as the father of the country or reducing the threat to his position posed by poor economic performance. For present purposes the key is not that the regime leaders get a psychic benefit from pursuing economic development, but that they choose to pursue non-pecuniary as opposed to pecuniary private benefits. As we will discuss, the preference for growth by the economically benevolent autocrat is crucially supported by assurances that economic actors will be able to keep the fruits of their investments. See infra text at notes 152-155.

cases were monstrous – along other dimensions. Moreover, autocracies on average have produced no better (and by some measures lower) economic growth than weak democracies,[5] the only other horse in the race.[6] But our thesis is that not all autocratic regimes are the same; the performance of such regimes in, for example, Korea, Taiwan, Chile, Singapore, and China, was dramatically better than average. In those countries, perhaps through sheer luck, the regime leaders had different ambitions, and as a group they did much better than both other autocracies and less repressive regimes.[7]

As we will elaborate later, however, we hardly mean to suggest that sensible policy is to seek out economically benevolent dictators to staff the transition of developing countries. Serendipity, not planning, explains the appearance of growth-seeking autocratic regimes. Rather, our goal is to identify functionally what these regimes did to effect the necessary transition, and to assess what other less repressive institutions might substitute for dictators in accomplishing these tasks. To anticipate our argument, emerging democracies cannot easily provide the credible commitment to protect the returns of those who need to invest their financial and human capital for growth to occur. The risk remains that future governments will descend into rent seeking

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[5] Studies include Dani Rodrik, Institutions for High-Quality Growth: What They are and How to Acquire Them, 35 Stud. In Comp. Int'l Dev. , Issue 3 at 3 (2000); Christopher Clague, Phillip Keefer, Stephen Knack & Mancur Olson, Property and Contract Rights in Autocracies and Democracies, 1 J. Econ. Growth 243 (1996); Adam Przeworski & Fernando Limongi, Political Regimes & Economic Growth, 7 J. Econ. Persp. 51 (1993); Robert J. Barro, Democracy and Growth, 1 J. Econ. Growth 1 (1996); Aymo Brunetti, Political Variables in Cross-Country Growth Analysis, 11 J. Econ. Surveys 163 (1997). The literature is reviewed most recently in Jose Antonio Cheibub, Jennifer Gandhi & James Raymond Vreeland, Democracy and Dictatorship Revisted, 143 Public Choice 67 (2010); Dixit, supra note 5.

[6] Our colleague Charles Sabel reminds us that our list leaves out Western democracies like Finland and Ireland that have successfully developed. Both these countries, however, were mature democracies. Our focus here is on the more typical developing country, where the political choices are limited to dictators and weak democracies.

[7] Consistent with our view, Joseph Wright's empirical assessment suggests that differences among autocratic regimes accounts for much of the variance in results in comparisons of the economic growth of autocratic and democratic regimes. Joseph Wright, Do Authoritarian Institutions Constrain? How Legislatures Affect Economic Growth, 52 Am. J. Pol. Sci. 322 (2008)

and promote policies that devalue prior investments. Economically benevolent autocracies can provide that commitment, at least for a period of time. Our aspiration is to learn from the experience of economically successful autocratic regimes how to fashion functionally equivalent strategies for emerging democracies. As initial examples of this approach, we will examine the potential for regional commercial courts, unorthodox investor protection mechanisms, and creative contracts to substitute for part of the dictator's function.

We also recognize that identifying and evaluating the role played by economically benevolent autocracies will be to a significant extent context specific, which also will make it difficult to generalize without a deep account of each successful regime's experience. We will not undertake that entire project here. Rather, our aim is to motivate that larger project by showing that our theoretical account, supported by case studies of several economically successful, but quite different autocratic regimes, is plausible. Our case studies include South Korea under Park Chung-Hee, Chile under Augusto Pinochet, and China under Deng Xiaoping and his successors.

We also hope to shed some light on the recent emphasis in development theory on the central role of institutions. Suppose that the institutionalists have got it right – what ultimately is needed for lasting growth are formal institutions that support arm's length capitalism.[8] How then do we get those institutions? Nearly two decades of work by the World Bank and other international financial organizations, supported by a considerable amount of scholarship, suggests that effective formal legal institutions and an

[8] William Easterly, Institutions: Top Down or Bottom Up, 98 Am. Econ. Rev. 95 (2008), nicely captures in a handful of pages the debate over the role of formal institutions in supporting exchange and investment. Kevin E. Davis & Michael J. Trebilcock, The Relationship Between Law and Development: Optimists versus Skeptics, 56 Am. J. Comp. L. 895 (2008), provides a more complete account.

independent judiciary are indispensible attributes of successful development. Yet precisely because each country's history and capacities will be deeply path dependent, and because building credible formal institutions is a time consuming task, we need a stable of approaches to building the institutions necessary to success.[9] The variety of methods used even in different autocratic regimes may serve as a catalogue of options that can be adapted to a particular country's circumstances and accomplished by less repressive methods. As Franklin Allen and Jun Qian's work has stressed, for example, the institutions China has used to support market-based exchange are very different from Western institutions that accomplish the same result, even while Chinese institutions may be moving toward more Western structures.[10] At the very least, understanding the means by which non-democratic regimes transformed their economies without high quality formal legal systems should unsettle assumptions about the required *character* of institutions for growth, and shift the inquiry to their essential *functions*.

Finally, we believe that our examination of the Chilean and South Korean experiences under authoritarianism provides insights into the potential for political liberalization in China. Many commentators casually cite these experiences in support of a tight linkage between economic development and eventual political liberalization. Our perspective, which focuses on the role of business elites under authoritarian regimes, provides an alternative and generally less sanguine approach to the question of China's political future.

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[9] Dani Rodrik makes the same point with respect to the promulgation of best practice codes. "Best-practice institutions are, almost by definition, noncontextual and do not take into account … complications. Insofar as they narrow rather than expand the menu of institutional choices available to reformers, they serve the cause [of development] badly." Dani Rodrik, Second-Best Institutions, 98 Am. Econ. Rev. 100, 104 (2008).
[10] Franklin Allen & Jun Qian, Comparing Legal and Alternative Institutions in Finance and Commerce, Working Paper (Oct. 2008), available at http://www.ssrn.com.

Part I sets out the analytic framework: the capacity of a growth-favoring autocracy to credibly commit to investors that the return on their investments will not be dissipated by rent seeking. Part II then puts the problem of credible commitment in context. Developing countries can experience quite dramatic initial growth through relational contracts, without the need for formal contract enforcement or informal government encouragement of contract performance by domestic parties. However, breakthrough economic development, by entering the arena of global commerce, requires moving beyond carefully nurtured relational contracting to more arms' length trading. As we will see, the difficulty is one of political economy: existing elites, whose position depends on their success in a relationally based economy, may resist the changes that will increase total output at the expense of their share. In this account, the critical role of economically benevolent autocratic regimes is to impose – or perhaps more accurately negotiate – the shift to a different set of complementary institutions. Part III then surveys the experience of three quite different countries to highlight what economically benevolent regimes have done to facilitate the transition. South Korea experienced a military coup that explicitly sought an "industrial revolution," influenced by the experience of Meiji Japan. In Chile, democracy characterized by rampant rent seeking was replaced by a military dictator, whose regime embraced a free market policy informed by economists trained at the University of Chicago. Finally, in China the Communist Party embraced a policy focused on economic growth, led in part by state owned enterprises, with the state playing a role that curiously recalls that of the general partner of a private equity fund. Part IV undertakes a comparative analysis of these three quite different experiences of development under autocracy. Part V then addresses the lessons of our analysis for developing democracies, such as the potential for a regional commercial court to provide participating countries with a commitment device they could not create individually. Finally, Part VI concludes by considering the relevance of our analysis to a vexing problem – the relationship between economic growth and democracy, where the direction of causality has enormous policy implications.

I. The Analytic Framework

Our effort here is to explain the following pattern. As an empirical matter, it is a close race on average between emerging democracies and autocratic regimes in terms of which form of government is associated with higher growth rates in developing countries.[11] As a matter of theory, it is hard to predict a winner, since each form of government is subject to a different but debilitating flaw. Autocratic governments are prone to kleptocracy where the most significant export is of capital to private Swiss bank accounts.[12] Weak, or unconsolidated democracies are prone to interest group rent seeking that expands the range and magnitude of poor economic policies whose purpose is to pay off the interest groups rather than to support growth. These policies increase uncertainty and correspondingly decrease the incentives for private investment.[13] This concern over the political economy of interest groups mirrors that raised many years ago with regard to a particular still-weak democracy – the threat to U.S. development posed by factions that Hamilton highlighted in the Federalist papers. As Tolstoy stresses with respect to unhappy families in Anna Karenina, there is no single way to fail.[14] The problem we address here is that there seems to be no clear way to succeed.

[11] See the sources in note 5 supra.
[12] See note 4 supra (literature "assumes all rulers are driven by private objectives").
[13] Easterly, supra note 1.
[14] Leo Tolstoy, Anna Karenina 1 (Barnes & Noble Classics ed. 2003).

The autocracies whose successful development we will canvass in Part III have not followed a single development strategy. Indeed, the three case studies we offer here were chosen for this reason. Chile followed an explicitly University of Chicago-influenced strategy that dictated a dramatic opening of its markets. Korea, in contrast, created an export-oriented economy with government supported champions chosen from among the existing elite and protection of domestic markets. China has followed a state-led, export oriented policy, with fairly open markets, but with the state playing a role resembling the role played by another autocratic champion of transitions – the private equity investor.

The problem, then, is to explain this odd pattern of examples: governments that share a common structural characteristic, but with a diversity of strategies, all of which have led to successful development. Counter intuitively, a central feature of our account is that the choice of a particular development strategy is not the key to understanding patterns of development. Rather, from our perspective, the starting point is the preferences of the decision maker, whether lawmakers and bureaucrats in a democratic government or a benevolent despot in an autocracy, and the decision maker's capacity to credibly commit to a growth strategy –almost any rational growth strategy – that seeks to implement those preferences. Given the presence of these two elements, the choice of a particular strategy is less significant. In the abstract, and given a credible commitment, a number of strategies will work, with diversity resulting from each country's choice of a strategy that is complementary to its endowments and to the time it develops.[15] Although

[15] Dani Rodrik, Arvind Subramanian & Francesco Trebbi, Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development, 9 J. Econ. Growth 131, 157-58 (2004), write: "There is growing evidence that desirable institutional arrangements have a large element of context specificity, arising from differences in historical trajectories, geography, political economy, or other initial

different strategies may differ in comparative effectiveness depending on the state of the world and the institutional endowment on which a particular country builds, that is also true of developed economies. As Hall and Soskice show, liberal market economies (think Anglo-Saxon) and coordinated market economies (think Germany and Japan) build on different structures and can be expected to be more or less effective depending on the time and the particular production technology.[16] Put differently, economic growth requires private investment – in industrial and human capital – that will be made only if investors believe that supportive policies will be followed. Therefore, our prediction is that growth depends in the first instance on a government that wants to grow the size of the pie, rather than protect the size of the pie taken by a favored few. A small number of autocracies have this preference, although most do not. Those that do represent the serendipitous initial position of a path dependent process.

We note, however, that our ecumenist approach to growth strategy is not entirely without limits. Joseph Stalin was in a sense an economically benevolent dictator.[17] In a period when successful development was seen as a function of growth in heavy industry (although this was linked to the political goal of establishing a central role for the Soviet

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conditions. … This could help explain why successful developing countries – China, South Korea, and Taiwan among others – have almost always combined unorthodox elements with orthodox policies." See Dani Rodrik, Second-Best Institutions, supra note 9, ("Best practice institutions are, almost by definition non-contextual."); Ronald J. Gilson, Corporate Governance and Economic Efficiency: When Do Institutions Matter, 74 Wash U. L.Q. 327, 334 (1996) ("Each system solves the problem in the peculiar context of its own path dependent institutions. In evolutionary theorist Stephen Jay Gould's terms, the solutions are "jury-rigged from a limited set of available components."); Gustav Ranis, Diversity of Communities and Economic Development: An Overview, Dept. of Econ. Working Paper, Yale Univ. (Sept. 2009), available at http://ssrn.com/abstract=1475329 (Ethnically polarized societies more likely to engage in rent seeking; initial conditions are important determinants of adverse development outcomes).

The standard reference for development strategy being contingent on when a country develops is Alexander Gerschenkron, Economic Backwardness in Historical Perspective: A Book of Essays (1962).

[16] Peter A. Hall & David Soskice, Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (2001).

[17] The example dramatically illustrates that benevolence along the economic dimension leaves room for monstrous inhumanity along others.

Union on the international stage), Stalin succeeded in bringing about significant economic growth. However, a planned economy strategy has proven to be a fatally flawed basis for growth. The failure of command economies represents the limiting case of our relative lack of concern among particular growth strategies.

An element in addition to the decision maker's preferences, however, is necessary, and it is this element that we argue can give the economically benevolent autocracy an edge over emerging democracies in supporting growth. An autocrat's idiosyncratic preference for a growth-oriented regime rather than a kleptocracy must be matched by a credible commitment to economic actors that their investments will be respected and that they will be allowed to keep the gains from their initiative and efforts, rather than see them dissipated by policy changes that favor politically influential interest groups. Investors fear not just direct expropriation, but also a regulatory expropriation through policy--for example, changes in import restrictions or exchange rate regulation[18] that devalue their investment.[19] This is not a simple institutional story; it is not enough, for example, to set up formal institutions of the character championed by best practice codes promulgated by the IMF, World Bank and other international financial institutions.[20] Russia, for example, adopted an ingenious corporate statute, devised and drafted with the assistance of talented U.S. legal scholars deeply familiar with Russia's

[18] See Easterly, supra note 1, (reviewing examples of regulatory disincentives for investment).
[19] See, e.g., William A. Fischel, Regulatory Takings: Law, Economics, and Politics (1995).
[20] See, e.g., Katharina Pistor, The Standardization of Law and its Effect on Developing Economies, 50 Am. J.Comp. L. 101 (2002); Dan Berkowitz, Katharina Pistor & Jean-Francois, Economic Development, Legality, and the Transplant Effect, 47 Eur. Econ. Rev. 165 (2003).

circumstances.[21] The new corporate law failed because the institutions purportedly created were not credible – they did not provide the protection promised by the statute.[22]

According to our hypothesis, it is the ability to credibly commit to sustaining the institutions necessary to support business and human capital investment that explains the success of economically benevolent autocracies. While the fact of their leaders' preferences is idiosyncratic -- the serendipity of initial positions -- their capacity to credibly commit is not. By contrast, emerging democracies have more difficulty creating and sustaining credible institutions to assure entrepreneurs that rent seeking will not compromise their ability to profit from their efforts. In the next section, we place the problem of credible commitment to economic growth in context.

II. The Context: Transition to a Global Market

Breakthrough economic development requires that investors be protected from two threats to their investment, one from the state and one from opportunism by trading partners. As we have seen, the first category implicates the protection of investment returns—a credible commitment by the state that it will neither directly expropriate private investment nor indirectly expropriate the future earnings from current investment through policy changes that favor powerful interest groups. The second category is the realm of government assistance in protecting economic actors against opportunism by their contracting parties,[23] as we will see, a necessary condition for the country's

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[21] Bernard Black & Reinier Kraakman, A Self-Enforcing Model of Corporate Law, 109 Harvard Law Review 1911 (1996).
[22] See Reinier H Kraakman, Bernard Black & Anna Tarassova. Russian Privatization and Corporate Governance: What Went Wrong? 52 Stan. L. Rev. 1731 (2000)(explaining Russian failure).
[23] Note that we frame the question as one of government encouragement of contractual performance rather than simply the formal encouragement of contractual performance through the creation of a court system and judicially imposed remedies for breach of contract. As discussed infra note 38 and accompanying text, effective courts can be expected to take a lengthy period to develop. In the meantime, the government can encourage performance by domestic contracting parties in less formal ways.

expansion of its market by entry into global commerce, in turn a precondition for growth.[24] It is the second category – government assistance in the enforcement of contracts – that will be our principal concern here.

A. Reputation-Based Trading

Developing countries typically lack effective formal enforcement of contracts. Douglass North identified self-enforcement as the core of commerce in such economies. At its most simple, self-enforcement depends on the expectation of a lengthy series of future transactions between the same parties;[25] neither party will have an incentive to cheat in a particular transaction because bad behavior by a party in one transaction will be punished by the counterparty in a future transaction.[26] But reciprocity-supported exchange has significant limitations. Most importantly, the requirement of long-lasting bilateral exchange to support self-enforcing exchange greatly limits the number of long-term trading partners available, and therefore, the size of the economy.[27]

Expanding the number of trading partners then requires adding the concept of reputation. If trade will be multilateral rather than bilateral – that is, if one party will trade with others in the future but not necessarily with any single counterparty repeatedly – self-enforcing trade requires that traders develop a reputation. Such multilateral exchange requires that a party's behavior in one exchange must become known to potential partners in future exchanges.[28]

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[24] As Romer puts it, "[W]hat is important for growth is integration not into an economy with a large number of people but rather into one with a large amount of human capital… . [G]rowth seems to be correlated with the degree of integration into worldwide markets… ." Romer, supra note 3, at 598.
[25] See North, supra note 2.
[26] See, e.g., Avinash Dixit, Lawlessness and Economics: Alternative Modes of Governance 16-17 (2004).
[27] See Gilson, supra note 2, at 638-39.
[28] Id.

Reputation based trading has inherent limitations. In order for the anticipation of future trading parties' actions to influence a trader's current behavior there must be a shared understanding of what constitutes breach of performance, and the trader's current behavior must be observable to potential future counterparties. Avinash Dixit characterizes these limitations in terms of the distance between trading partners. The greater the physical distance, the more costly it is for future trading parties to obtain information about a party's past performance, and to develop a shared understanding of performance or breach, particularly if the new counterparties are also socially distant, in terms of culture, language or class.[29] Also, new or more complex transactions require more costly information to support self-enforcement; understanding what constitutes performance requires both more and different information, without the shared information associated with more traditional markets. As Dixit puts it, the result is straightforward: "cheating becomes more attractive the more distant the partner."[30]

The scope and scale of a reputation market is thus self-limiting. At some point, the gains from trading with more distant partners are outweighed by the costs necessary to support reputational trading. The pattern of family owned conglomerates in developing countries in part represents an effort to take advantage of scale and scope advantages with respect to an existing reputation, but that strategy also comes with a cost: less efficient production as a result of entering product markets with which the company has no experience.[31] And so the growth curve flattens out. While a reputation-based

[29] "Cultural beliefs and behavioral norms coordinate expectations and provide a shared understanding of the meaning of various actions." Avner Greif, Commitment, Coercion, and Markets: The Nature and Dynamics of Institutions Supporting Exchange, in Handbook of New Institutional Economics 727, 762 (Claude Menard & Mary M. Shirley eds. 2005).
[30] Avinash Dixit, supra note 26 , at 70.
[31] Gilson, supra note 2, at 651-52. Conglomerates in developing countries also can serve to internalize allocation of capital in countries where the capital market is inefficient. See, e.g., Tarun Khanna & Krishna

commercial system can grow quickly, it ultimately runs into an upper bound.[32] Thus, as developing countries seek to integrate into global trading markets, reputational markets ultimately must be supplemented by government assistance in assuring contractual performance – as North frames it, "the development of the state as a coercive force able to monitor property rights and enforce contracts effectively."[33] In North's view, the absence of effective penalties for opportunistic behavior by contracting parties limits the scope of the market and is a central cause of the persistence of underdevelopment.

B. The Transition Problem

This brings us to the problem of transition: How do developing countries accomplish the shift from reputational to state encouragement of performance of commercial obligations? Here there are serious problems concerning both the state's will, and the availability of a method, to accomplish the transition.

1. The Olson Problem

The shift from relational enforcement of commercial obligations to third party enforcement presents a cruel dilemma. The economic elite in a developing country likely are those who are also the political elite – precisely the groups who have succeeded in the existing relationally based system. They have the greatest system-specific investment in reputation and the most to lose from changes in state policies that have been shaped to favor them. They therefore have the most to lose from the reduction in entry barriers that results from effective state encouragement of contractual performance. Following

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Palepu, Is Group Affiliation Profitable in Emerging Markets: An Analysis of Diversified Indian Business Groups, 55 J. Fin. 867 (2000)(explaining the advantage of an internal capital market in emerging market juridictions).

[32] Avinash Dixit, supra note 26 at 82; John Shuhe Li, Relation-Based Versus Rule-Based Governance: An Explanation of the East Asian Economic Miracle and Asian Crisis, 11 Rev. Int'l Econ. 651, 651 (2003).

[33]North, supra note 2, at 59.

Gilson, Hansmann and Pargendler,[34] we call this the *Olson problem*, after the economist who described the problem most effectively.[35] Mancur Olson argued that these groups would have both the incentives and the resources to make more difficult or to block the development of formal institutions that devalue the incumbent elite's investment and position in the existing system.[36]

Rajan and Zingales address the Olson problem in the path dependent context that we apply here, although they come at it from the opposite side. While we seek to explain how particular countries overcame the barriers to transition to third party enforcement by creating the necessary supportive institutions, Rajan and Zingales address the barriers that lead to persistent underdevelopment by preventing the development of those institutions. Following Olson (but without referring to him) in focusing on the underlying political economy of transition, they conclude that "the persistence of underdevelopment is not necessarily due to the existence of bad political, and consequently economic institutions. Institutions may often be only the proximate cause. The deeper reason is the existence of self-perpetuating constituencies. Changing explicit institutions without changing the constituencies backing them is likely to be a futile exercise."[37]

Developing countries thus face a significant political economy question in making the transition from reputation-based enforcement to governmentally encouraged

[34] Ronald J. Gilson, Henry Hansmann & Marina Pargendler, Regulatory Dualism as an Economic Development Strategy: Corporate Reform in Brazil, the U.S., and the EU, forthcoming, Stan. L. Rev., 2010), available at http://www.ssrn.com/abstract=1541226.
[35] Mancur Olson, The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities (1982).
[36] Gilson, supra note 2, at 653.
[37] Raghuram G. Rajan & Luigi Zingales, The Persistence of Underdevelopment: Institutions, Human Capital, or Constituencies, working paper (Feb. 2006), available at http://www.ssrn.com. Dixit makes a smiliar point: "[T]he fixed costs of rule-based governance are a public investment; therefore society must solve a collective-action problem to put such a system in place. This is not automatic; there are the usual problems of free riding, underestimation of the benefits to future generations in today's political process, and the veto power held by those who stand to lose from the change." Dixit, supra note 26, at 44.

performance of commercial obligations. The necessary reforms will serve to increase the size of the pie, but at the expense of shrinking the piece of the pie – both in economic and, as a result, political power – of those whose cooperation is necessary to effect the change.

2. The Non-Political Difficulties of the Transition

A developing country seeking to join the global economy by moving toward third-party enforcement confronts more than problems of political economy. It also confronts serious economic difficulties associated with making the transition. Two points are critical to the analysis. The first is that government institutions providing formal third-party enforcement take time to establish – credibility comes only after investors are persuaded that they work. After a formally independent judiciary is established economic actors must accumulate sufficient experience to believe that the courts work quickly, reasonably accurately, and honestly. Intuitively, this period is likely measured in generations, an intuition confirmed in a number of studies of judicial performance in developing countries.[38]

What happens in the meantime makes things worse. During what may be a lengthy transition period, economic growth can slow or turn negative as existing relation-based institutions become less efficient and their replacement by third-party enforcement institutions remains incomplete. Dixit shows that a partial improvement in third-party enforcement can undermine the performance of an existing system of relational enforcement by actually reducing the consequences of cheating.[39] Milgrom and Roberts

[38] Jens Dammann and Henry Hansmann collect the studies. Jens Dammann & Henry Hansmann, Globalizing Commercial Litigation, 94 Cornell L. Rev. 1, 10, n.22 (2008).
[39] Dixit, supra note 26. This is consistent with the experimental literature suggesting that under some circumstances the introduction of formal enforcement into a relational contract "crowds out" the previously

argue persuasively that the deterioration in economic performance associated with transition may be significant. A path dependent commercial system has important complementarities between its segments. Each element of the system is chosen sequentially so that it fits – that is, it not only adds its independent contribution to performance, but increases the performance of already existing elements, a phenomenon Milgrom and Roberts call "supermodularity."[40] The same characteristics that made the economy grow so quickly during its early development then operate as a barrier to transition: "Even if a coordinated adjustment on all relevant dimensions might yield an improvement in performance, it may be that until all the features of the new pattern have been implemented, the performance of the system may be much worse than in the original position."[41] John Shue Li attributes the transformation of the "East Asian miracle" into the "Asian [financial] crisis" to this pattern: "The dismantling of too many exiting relation-based mechanisms in so short a period can damage the future potential of economies at an early stage of development to continue to catch up; i.e., before reaching the turning point where relation-based governance is still more cost-effective than rule-based governance …."[42]

And now the political economy problem again rears its ugly head. A successful transition requires sustaining a strategy – say reducing trade barriers – that in the short run may make everyone worse off. This is a serious problem in an emerging democracy

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effective informal arrangement. See Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine, 110 Col. L. Rev. (forthcoming 2010), available at www.ssrn,com.

[40] Paul Milgrom & John Roberts, Complementarities and Systems: Understanding Japanese Economic Organization, 9 Estudios Economicos 3, 12 (1994). John Roberts, The Modern Firm (2006), provides an overview of the complementarity analysis of systems, and catalogues Milgrom and Roberts' extensive work on complementarity in business systems and manufacturing.

[41] Milgrom & Roberts, supra note 40 at 12.

[42] Li, supra note 32 at 669.

where many voters live on the edge and therefore one might expect that the endowment effect – the tendency to overvalue losses compared to gains – would dissipate support for the transition. The interaction of a transition-induced deterioration of performance with a weak democracy produces, as Rajan and Zingales term it, the persistence of underdevelopment. In the absence of the government having the capacity to credibly commit to maintain policies that support growth, investors will not make the necessary investments in businesses and human capital.[43]

C. Economically Benevolent Autocracies

We are now at the point when we can see the potential advantage offered by an economically benevolent autocracy. The political economy problem mirrors a problem that Acemoglu and Robinson identify in transitions to democracy.[44] They posit a game played between elites that have power and wealth, and non-elites who would benefit from policies more favorable to them than to the elite. Non-elites will revolt unless they get policies that improve their positions, although at the expense of the elites. The rational equilibrium is a compromise, because a revolt destroys wealth and makes both sides worse off by leaving less wealth to share. The problem is how to make a compromise credible – what will keep the elites from reneging on their promises to share once the non-elites stand down? For Acemoglu and Robinson, the answer is a shift from an authoritarian government controlled by the elite, and whose representations of future policy cannot be made credible, to a democracy, which makes commitments to future

[43] "This highlights that *commitment problems* arise when political power is not in the hands of the beneficiaries of the promised power." Daron Acemoglu & James A. Robinson, Economic Origins of Dictatorship and Democracy 132 (2006) (emphasis in the original).
[44] Id., at 120-32.

policy credible because some power over existing institutions is shifted to the non-elites.[45]

The transition to government encouragement of commercial performance that is necessary to allow economic growth follows much the same logic, but with the direction of the movement between democracy and autocracy reversed. The transition necessary to sustain growth means taking something away from the elite, who are successful in the existing relational economy. And while the new growth-oriented equilibrium will be beneficial to the non-elites by opening entry to them, the transition problem of lowered performance that can be expected to make non-elites worse off causes a shift of power to the non-elites to fail because the non-elites will abandon the effort.[46] Thus, the commitment to growth-supporting institutions is not credible, and investment does not occur. Consistent with the conclusion of Rajan and Zingales (although the logic differs), emerging democracies have difficulty sustaining growth because there are no constituencies that can be counted on to support the transition; the elites lose from the transition, and the non-elites cannot see their way past the transitional downturn.

Here is where the economically benevolent autocracy comes in. Whether the Park regime in Korea, the Pinochet regime in Chile, or the Chinese Communist Party, an autocracy can, with the backing of the military, credibly commit to transition policies, including especially the power to stay with the policies through the transition downturn. One of those policies is government assistance in encouraging the performance of commercial obligations.

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[45] Id.

[46] Cf. Adi Brender & Allan Drazen, Why is Economic Policy Different in New Democracies? Affecting Attitudes about Democracy, NBER Working Paper 13457 (Oct. 2007), available at http://www.nber.org/papers/w13457 (economic performance is key to regime survival in new democracies through mechanism of citizen attitudes).

This brings us to our three case studies: economically benevolent regimes in Korea, Chile and China. Our hypothesis is that the central feature of these three regimes is their ability to credibly commit, not to a particular development strategy, but to a strategy available to the particular country at that moment in time. Put differently, the development strategy is path dependent, pulled together from the tools made available by the country's history and the time when development takes place.[47] A second point is also important. As we have argued, critical to a successful transition is the establishment of credible government encouragement of commercial performance. In much of the literature, the necessary mechanism for this transition is assumed to be Western style courts. Although the World Bank has encouraged the formation of judicial systems in developing countries, the failure of that undertaking has been repeatedly noted.[48] Our view is far more functional in character. An autocratic government can penalize domestic parties informally for breaches of contract that interfere with arms' length contracting in the global market. For example, state support for designated business groups can be withdrawn or reduced as a penalty for development-threatening behavior without the need for formal courts, as was the case in Korea.[49] Similarly, China has provided increasingly credible commitments with respect to dispute resolution, although

[47] Each system is "jury-rigged from a limited set of available components" supplied by that system's history. Stephen Jay Gould, Panda's Thumb: More Reflections in Natural History 20 (1980). See note 15 supra.
[48] See note 18 supra.
[49] See infra note 65 and accompanying text. The point in the text can be put more broadly. An effective government, including those in developed countries, can make use of such informal government penalties for violations of expectations rather than legal obligations. For example, the non-legal obligation of a Japanese main bank to "rescue" a troubled client company was said to be enforced by the Ministry of Finance's discretionary power to approve the opening of new bank branches. A bank that did not meet the Ministry of Finance's expectations would not receive approval of applications for new offices. See Masahiko Aoki & Hugh Patrick, The Japanese Main Bank System, in The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies 3 (Masahiko Aoki & Hugh Patrick eds., 1994).

the institutions do not closely resemble those of Western courts.[50] It is an open question whether convergence of form will ultimately take place, an issue that will depend on the evolution of the particular autocratic government. We will touch on this issue in closing, but without the conceit of trying to resolve it here.

III. Development Under Autocracy: Three Country Narratives

We explore our hypothesis by examining three of the most remarkable development stories of the late twentieth century: South Korea under Park Chung-Hee, Chile under Augusto Pinochet, and China under Deng Xiaoping and his successors.

A. South Korea

South Korea is one of the great economic success stories of the twentieth century. Although it seems impossible to imagine today, in 1970 it was debatable whether the North Korean or South Korean economy had more potential. In 1965, per capital income in the South was $100. Fuelled by an export-led growth strategy, however, the South Korean economy boomed over the ensuing decades. Its export sector expanded from 4% of GNP in 1964 to 40% in 1985.[51] In 1995, per capita income reached $10,000;[52] by 2005, it had grown to $16,000. Today, while its communist counterpart to the North languishes in abject poverty and experiences bouts of starvation, South Korea is the world's fourteenth largest economy.

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[50] Allen & Qian, supra note 10, stress that China has successfully made the transition to participation in the global market without formal legal institutions. However, they assign the credit for success entirely to standard relational contracting, in our view incorrectly ignoring the role of the government in directing the commercial behavior of Chinese companies.
[51] FRSB Weekly Letter, Dec. 4, 1987, Korea and Export-Led Growth.
[52] OECD Economic Reports: Korea, 23 (2004).

The key moment in Korea's economic takeoff came during the presidency of Park Chung-Hee, which lasted from 1961 until his assassination in 1979. While presiding over an authoritarian regime "characterized by the brutal suppression of political dissidents and labor activists, as well as the exclusion of the populace from politics," Park "played a central role in transforming South Korea from one of the poorest countries in the world in the early 1960s into a developing country in the late 1970s."[53] As we will explore below, Park accomplished his economic goals by mobilizing the only viable economic resource in the country at the time, a nascent class of entrepreneurial talent, and by forging a growth pact between their firms and his government.

To fully understand Korea's high growth in the 1970s, it is helpful to review the country's early twentieth century history. Park's policy choices were influenced by the country's, as well as his own, experience under Japanese colonial rule from 1910-1945. The Japanese made heavy use of the Meiji economic model in Korea. Apropos of that model, the relentless focus of the colonial state was development of the Korean economy. Economic growth was elevated to a national mission, and development was orchestrated by an effective bureaucracy that became extensively involved in economic planning and management. As one economic historian puts it, the colonial state became "heavily and directly involved in economic tasks, and judged strictly by economic criteria, performed those tasks with ruthless effectiveness."[54] Again drawing on the Meiji model, however, the colonial state also gave Japanese business groups, as well as an emerging class of local landowners and entrepreneurs, a major role in the process of industrialization. To this end, the state "employed a variety of carrots and sticks to incorporate the propertied

[53] Seungsook Moon, Cultural Politics of Remembering Park Chung Hee, 51 Harvard Asia Quarterly (2008).
[54] Atul Kohli, Where Do High-Growth Political Economies Come From? The Japanese Lineage of Korea's "Developmental State," in Meredith Woo-Cummings, The Developmental State, 93, 111 (1999).

groups in a production-oriented alliance."[55] Korean businesspeople lost considerable autonomy under this alliance, but they profited handsomely from state-led industrialization.[56] Korea's colonial legacy thus included a disciplined and effective bureaucratic infrastructure pervasively involved in economic policies, and an entrepreneurial class accustomed to working within a state-dominated alliance in pursuit of export-oriented growth.[57]

The U.S. occupation of Korea after Japan's defeat in World War II was followed from 1948 to 1960 by a period of corrupt and ineffective rule under President Syngman Rhee. A version of the public-private sector alliance that had developed in the colonial period re-appeared under Rhee in highly corrupt form. In the aftermath of World War II, a new group of businessmen emerged through acquisitions of state-owned enterprises and other commercial activities. As they sought government support for expansion, a highly clientelistic relationship between the economic bureaucracy and the business sector developed. The Rhee regime, which relied heavily on U.S. foreign aid, proved incapable, due to corruption and political weakness, of pursuing coherent development policies.[58]

When General Park Chung-Hee seized power in a military coup in 1961, economic development became the overriding goal of the state. Several reasons for Park's emphasis on growth are plausible. First, the colonial experience provided an institutional memory for the regime. Park had trained in a Japanese military academy in Manchuria and was fascinated by the Meiji model. He was convinced that Korea should

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[55] Id. at 115.
[56] For example, the largest Korean business group at the time obtained substantial government subsidies and financing from a bank controlled by the colonial government. Id. at 121.
[57] Id. at 116.
[58] Aid financed almost 70% of total imports from 1953 to 1961, and 75% of total fixed capital formation. Haggard et al, The Transition to Export-Led Growth in South Korea, 1954-66, World Bank Working Paper, WPS 546 (1990) at 3.

follow the Japanese path to modernity.[59] One historian of the period argues that under Park, South Korea "fell back into the groves of [its] colonial origins" because "the key elements of the eventual path it adopted…--a Japanese-style, state-driven export economy—were deeply etched into the social fabric."[60] Second, Park's regime—the product of a coup--lacked political legitimacy. The military justified its intervention into politics by reference to economic development. Park himself explicitly stated the case in 1962: "[T]he key factor of the May 16 Military Revolution was to effect an industrial revolution in Korea."[61] Although the United States was displeased with a military junta in Korea, it was eager to see reform of Korea's economic policies.[62] Economic development would serve as a stabilizing force on the peninsula and provide a bulwark against the existential threat from North Korea. Thus, a governing strategy focused almost exclusively on economic development simultaneously fit Park's personal conception of Korea's national destiny, was central to his own political (and possibly by extension, physical) survival, and advanced important strategic objectives of his indispensible supporter, the United States.[63]

Yet more than an idiosyncratic preference for growth by the political leadership was necessary to transform the country economically. Park also had to find (or create) actors capable of carrying out his developmental agenda, while making credible his regime's commitment to growth. Particularly given the country's poverty and climate of corruption, how were these sizeable challenges accomplished?

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[59] Kohli, supra note 54 at 130, citing Chong-Sik Lee. See also Karl Fields, Strong States and Business Organizations in Korea and Taiwan, 122, 128, in Business and the State in Developing Countries (Sylvia Maxfield & Ben Ross Schneider eds.(1997).
[60] Kohli, supra, ntoe 54 at 131.
[61] Stephan Haggard, Byung-Kook Kim and Chung-In Moon, The Transition to Export-Led Growth in South Korea, 1954-66, World Bank Working Paper, WPS 546 (1990) at 13 (quoting Park, Our Nation's Path).
[62] Id. at 21-27.
[63] Of course, both ended with Park's assassination in 1979.

Park hitched his quest for an "industrial revolution" in Korea to the one resource at his disposal--the entrepreneurs who had emerged under the previous regime. One of Park's first policy initiatives following the coup had in fact been to prosecute this class of businessmen for corruption. But he pulled back upon the realization that "the only viable economic force happened to be the target group of leading entrepreneurial talents with their singular advantage of organization, personnel, facilities and capital resources."[64] A central figure in the military junta put it simply: "It was essential to co-opt [the business sector] in order to carry out revolutionary tasks."[65]

Like its colonial forebears, the Park government created an implicit alliance with the existing entrepreneurial elites in pursuit of economic development. The terms of the alliance were straightforward: the government identified strategic industries and corporations to be supported; favored firms expanded with government-directed loans and developed key export-oriented industries under the protection of entry and exit barriers provided by the state. For example, licensing requirements and trade protections ensured market access to favored firms, while government-orchestrated mergers and subsidized credit mitigated the ordinary market consequences of financial distress. In return, the entrepreneurs worked closely with the government and abided by the policy priorities of the regime. To carry out its industrial policy, Park's government brought the commercial banks under its control. It consolidated economic power in a handful of ministries and staffed the economic bureaucracy with talented and zealous personnel. The government provided low-cost credit to favored firms, and guaranteed loans from foreign banks at a time when fledgling domestic enterprises were not attractive to foreign

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[64] Haggard et al., supra note 61, at 16.
[65] Id., *quoting* Hyo-Jin Oh, Oh Hyo-Jin i Manan Saram: Kim Jong-Pil [Kim Jong-Pil: The Person Oh Hyo-Jin Met], Wolgan Chosun (Dec. 1986).

lenders and investors. To be sure, the strategy itself was not unique. In our view, what distinguished the Park regime from similar efforts of other developing countries was the regime's success in committing to the enterprise.

The businessmen responded to these policies by developing large, diversified conglomerates active across a range of strategic sectors. This pattern of interaction gave birth to the modern-day *chaebol* corporate groups that continue to play a central role in the Korean economy. Or as one commentator puts it, the *chaebol* "can be thought of as the brainchild of the government."[66] *Chaebol* structures still reflect their origins in the growth alliance with the Park regime. They feature a de facto holding company under the direct control of the founding entrepreneur or his heirs, and an elaborate web of subsidiaries—some with minority public investors, many without--bound together through cross- and pyramidal shareholding structures and interlocking directorates. These shareholding patterns magnify the voting rights of the founding family, allowing it to retain control over the group despite massive growth and diversification of the underlying businesses. Cross-subsidization of intra-group firms is common, and balance sheets show high leverage, reflecting the traditional reliance on debt finance for expansion.

As it developed, the state-*chaebol* relationship took on many characteristics of a bi-lateral monopoly. Long-term, stable relationships among a small number of players reduced uncertainty and increased incentives to cooperate. High switching costs made alternative strategies unworkable. The state and the *chaebol* became locked in a mutually interdependent relationship, for which continued growth was essential. The results of the

[66] Sung-Hee Jwa, The Evolution of Large Corporations in Korea: A New Institutional Perspective on the *Chaebol* 19 (2002). "Basically, the formation and growth of the *chaebol* was a result of the interaction between the government's industrial policies and the *chaebol*'s responses to them." Id. at 27.

bargain were dramatic: by the early 1980s, per capita income had reached $2000. Korea's five largest corporate groups employed almost a half million workers, and their sales accounted for 50% of GNP.[67] Park achieved Korea's industrial revolution and remained in power for nearly two decades until his assassination in 1979. For the business leaders allied with Park, economic growth not only provided substantial pecuniary and nonpecuniary benefits, it also muted public criticism of the *chaebol* groups' accumulation of wealth and power.

The regime's commitment to this implicit alliance for growth was secured in several ways. One was the potential long-term nature and stability of the Park government itself. Park was only 43 years old when he assumed power, and he ruled with the support of the military and the intelligence service, the most powerful institutions in Korean society at the time. In 1972, a new constitution effectively made Park president for life, enhancing the political stability of his government. Moreover, in the early years of his regime, Park's policies were susceptible to influence from the United States, on whom Korea relied for aid and military protection. The U.S. government was highly supportive of devaluation of the Korean currency and other policies that would promote export-led growth and economic stabilization. Parties dealing with the Park government thus had reason to expect that the regime would be long lived and, most important, that it would not veer dramatically from its emphasis on export-oriented economic development. These factors may have been particularly salient given the strategic focus on heavy industries such as chemicals and ship building, which require enormous initial capital investments.

[67] Fields, supra note 59, at 131.

Another crucial contributor to the credibility of the regime's commitment to economic growth was the relative "cleanliness" of the Park government, at least by developing country standards. Park himself is remembered as a thrifty and uncorrupt man.[68] Although corruption certainly existed under his regime, it never reached debilitating levels. In contrast to some other important examples such as Indonesia and China, government and military leaders avoided involvement in business enterprise. The private sector therefore did not face competition from firms affiliated with ruling elites, increasing the value of market privileges bestowed on private firms. The business sector was thus relatively secure in the expectation that as long as the economy grew, cooperation with the government would be rewarded with a reliable stream of rents. In turn, the central role of the military and intelligence service in the ruling structure assured that non-cooperation would be punished.

The small number of hand-picked members of the alliance also enhanced the credibility and efficacy of the arrangement. Small numbers permitted direct lines of communication between the public and private sectors, and allowed the government to closely monitor private sector performance and compliance with its policies. It also ensured that the rents from industrial development would not be dissipated through excessive competition among domestic producers. While the political and social repressiveness of Park's regime made obvious that the *chaebol* groups' continued success depended on maintaining their "joint venture" with the Park regime, in turn, the *chaebol* groups were protected to a significant degree by the law of small numbers: The scarcity of alternative entrepreneurial resources in Korea at the time constrained the regime's ability to change champions. The elite's economic interests were protected by the

[68] See e.g., Moon, supra note 53.

commitment of the regime, supported by mutually high switching costs, rather than by the rule of law.

To be sure, the Park regime was not averse to using the coercive power of the state to obtain cooperation from the private sector. While the regime did face high switching costs, the government's control over resource allocation provided the means to discipline large firms into pursuing its development objectives and limited opportunistic behavior. All firms were required to join industrial associations formed under state initiative as a means of gathering information and mobilizing support for government policy.[69] And although never strictly enforced, one of the Park government's first acts—the passage of a "Special Law for Dealing with Illicit Wealth Accumulation," subjecting businessmen to arrest and confiscation of their assets for engaging in corrupt activities under the Rhee regime—immediately brought the business leaders into a more subservient position vis-à-vis the state.[70]

Yet overall, Park's regime pursued governance strategies plainly favorable to the major firms. As in the colonial period, authoritarian rule provided a form of social order conducive to economic growth.[71] Organized labor in particular, but also other social groups which posed a potential threat to industrialization, were relentlessly suppressed. These policies naturally slowed the growth of legal rights and protections that could potentially be used against favored economic actors. For example, the development of shareholders' rights was consciously restrained as a means of encouraging the *chaebol* groups to diversify sources of funding. Equity finance would be more palatable to major firms if the controlling shareholders did not have to worry about legal claims from

[69] Fields, supra note 59, at 135.
[70] Yeon-Ho Lee, The State, Society and Big Business in South Korea 25 (1997).
[71] See Kohli, supra note 54, at 106.

minority public investors.[72] Membership in the alliance with the government thus offered protection from a variety of ordinary market risks attendant to any private firm's operations, such as minority shareholder complaints, insolvency, and labor strife.[73] And while a link between a ruling government and business elites is commonplace in developing countries, what distinguished the Park regime was its commitment to economic development, to the creation on "non-excludable" goods.

As can be seen from this sketch, Park's bargain with the *chaebol* provided a rough but effective substitute for a formal legal infrastructure to support market activities in the transformative period of Korean growth. The bilateral monopoly locked in place by high switching costs generated its own set of high-powered incentives and monitoring devices. The legal system gained greater relevance only when the joint venture between the regime and the *chaebols* came under pressure from changes in Korea's domestic political climate and international economic aspirations. Demand for law – that is, for restrictions on the *chaebol's* protected status -- most saliently investor and labor protections, bankruptcy processes, and anti-trust regulation, and pressures for a more open political process, grew after the underpinnings of the high-growth bargain had been severely cracked in the 1990s. Korea's formal legal system today is much more highly developed, and the relationship between the government and the business sector is considerably more arms-length, than under Park or his military successors. Yet important bilateral monopoly qualities of the government-*chaebol* relationship remain to this day – the bargaining position of the parties shifted within the relationship rather than switching

[72] For an analysis of why minority shareholders in a country with weak investor protections may nonetheless be willing to invest in public firms dominated by their founders, see Sang Yop Kang, Understanding the Controlling Shareholder Regime, unpublished working paper (2010).
[73] See Lee, supra note 70.

costs dissipating entirely. As we will explore in Part VI, integrating the *chaebol* growth pact into a transparent legal system and democratically accountable government remains one of Korea's principal institutional challenges.

B. Chile

As Park's industrial revolution was gaining momentum in Korea, on the other side of the world another military government was embarking on a national economic transformation by vastly different means. In Chile, Augusto Pinochet and the military seized power in 1973 and pioneered radical free market reforms long before the "Washington Consensus" arose. In the 1990s, as Chile transitioned to democracy following the end of the Pinochet regime, the country achieved annual growth rates of 7 percent with the institutional foundation the regime created. But this is not the story of a carefully controlled experiment by Milton Friedman's disciples in the Southern Hemisphere leading to rapid growth and eventual democratization, as the capsule version of the "Miracle of Chile" portrays it. The reality is both more complex and more illuminating.

Again, a short history is helpful before focusing on the authoritarian regime's approach to development. From the Great Depression until the coup that brought Pinochet to power, Chile pursued a path of extensive government regulation and intervention in the economy. During the first half of the 1930s, Chile suffered an extremely severe output contraction, possibly the largest in the world in relation to GDP. The worldwide depression and collapse of free trade led Chile to pursue an import substitution strategy featuring the creation of numerous state-owned enterprises (SOEs), protective trade barriers, price regulation, and expansion of the welfare system. Despite efforts to diversify the export base, in the 1960s copper continued to represent more than 70 per cent of total exports.[74] These policies reached their apex with the elected socialist government of Salvador Allende, who sought to further expand the state's already significant control over the factors of production and distribution of goods and services in the economy.

The creation of state owned enterprises ("SOEs") was intended to encourage industrialization and alleviate Chile's economic vulnerability by diversifying its heavy reliance on copper exports. A state holding corporation (CORFO) was established in 1939 to promote industrialization directly (by creating new public enterprises) and indirectly (by financing private sector enterprises operating in high priority industries). By 1970, even before the Allende government came to power, most of Chile's largest firms were SOEs. The "entrepreneurial state" represented 21% of total investment, almost 5% of national employment, and 22.5% of demand.[75]

The development of national industry was fostered through extensive trade protections and controls. Price, wage and interest rate controls, set by administrative decree, were pervasive. A wide array of interest groups found protection from competition through the political process: virtually every profession and commercial activity was secured by high entry barriers or extensive regulatory requirements, reflecting the pervasive rent seeking in weak democracies highlighted by Easterly.[76] In the post-Great Depression twentieth century, the Chilean state became entrepreneur, planner, regulator and protector; the Allende government represented an acceleration of,

[74] Esteban Jadresic and Roberto Zahler, Chile's Rapid Growth in the 1990s: Good Policies, Good Luck, or Political Change?, IMF Working Paper WP/00/153, 2000, at 5.
[75] Daniel Wisecarver, Regulacion y Deregulacion en Chile: Septiembre 1973 a Septiembre 1983, Estudios Publicos No. 22 (1986).
[76] Easterly, supra note 1 at 257-59.

rather than a break with, prior patterns. By the time the military came to power in 1973, Chile was one of the most closed and heavily regulated economies in the world.

At the same time, successions of Chilean governments faced pressure to alleviate poor living conditions and inequalities affecting large segments of the population. Expenditures on education, housing, health care and pensions steadily increased. Public benefits were typically funded through expansionary monetary policies. By 1970, social programs accounted for 42.5% of government spending, equivalent to 10.5% of GDP.[77] As a result of these policies, Chile faced serious macroeconomic problems. Chronic inflation was the most severe. Ballooning government budgets and easy monetary policy led to annual inflation rates averaging 30% in the period 1940-1970.

These macroeconomic imbalances exacerbated social tensions and inequalities. Distortions brought about through the complex and protectionist regulatory scheme only worsened these problems. The Allende government responded by *amplifying* the policies that had been pursued to that point. Trade protectionism and price controls reached their peaks, land and corporate assets were expropriated on a large scale, and Chile became more isolated from international trade than ever. Violent confrontations ensued as social stability deteriorated along with the economic situation.

In the face of this turmoil, the military ousted Allende in a bloody coup in September 1973. The coup marked a dramatic departure, not only from Chile's history of democratic rule in the twentieth century, but also from prevailing economic policies and political economy interactions:

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[77] Romulo Chumacero, Rodrigo Fuentes, Rolf Luders and Joaquin Vial, Understanding Chilean Reforms, in Understanding Market Reforms in Latin America: Similar Reforms, Diverse Constituencies, Varied Results 94 (edited by Jose Maria Fanelli, 2007).

> [The military regime] pursued a "foundational" transformation of Chilean politics and society, and a consequent radical transformation of Chile's economy. In the second half of the 1970s and early 1980s major structural reforms oriented towards having a more open, competitive, private-sector driven and price-deregulated market economy were implemented. These reforms included privatization of state-owned enterprises, dismantling the protectionist state, regulatory framework changes to make it consistent with a more open and competitive society, trade liberalization, tax, financial and social security system reforms and overall market liberalization.[78]

The implementation of free market reforms under the Pinochet regime is often described as a carefully planned experiment conducted by Chicago-school economists who used Chile as their laboratory.[79] From that starting point, explanations of the Chilean experience tend to diverge in two directions: Some commentators draw a straight narrative line between the embrace of free market reforms, Chile's economic "miracle," and its eventual (re-)democratization.[80] Others, focusing on the considerable human cost of the Pinochet's regime's policies or the continued involvement of the state in some industries even after the military coup, portray Chile's economic success as a "myth."[81] But both accounts neglect the fact that the Pinochet regime's embrace of the market – as opposed to the protectionist strategy of the past or of the Park regime in Korea -- was not foreordained, and neither of the alternative perspectives on Chile's reform trajectory accurately captures the complex reality of the country's experience under Pinochet and beyond.

[78] Esteban Jadresic and Roberto Zahler, Chile's Rapid Growth in the 1990s: Good Policies, Good Luck, or Political Change?, IMF Working Paper WP/00/153, 2000, at 7.
[79] See, e.g., Naomi Klein, The Shock Doctrine, at 87 ("Out of this live laboratory emerged the first Chicago School state…")
[80] See "Chile's Road to Freedom, A Diary," by Jose Pinera, a Chicago trained economist who served as a minister in the Pinochet regime. Available at http://www.josepinera.com/pag/oag_tex_2liberyChile.htm.
[81] See, e.g., Klein, supra note 79, at 103-06; James M. Cypher, Is Chile a Neoliberal Success?, available at http://www.thirdworldtraveler.com/South_America/Neoliberal_Success_Chile.html.

Pinochet and the other military leaders who seized power in September 1973 began without a coherent plan to govern the country. They acted to remove what they considered to be the serious threat to national order posed by the Allende regime, not to replace it with a superior governance philosophy.[82] The military had no experience in politics or economic management. In fact, the interruption of democratically elected government from 1973 to 1989 was a major exception to political tradition in Chile. For several decades prior to the coup, the political establishment had marginalized the armed force's political role.

A lack of consensus on economic policy marked the first eighteen months of Pinochet's regime. While Allende was in office, a free market economic plan (known as "El Ladrillo, or "The Brick" for its voluminous size) had been developed semi-clandestinely by a group of naval officers and Chicago-school economists, who came to be known as the Chicago Boys.[83] These market-oriented intellectual voices drew important support and amplification from *El Mercurio*, a conservative newspaper. The Brick was prepared as an alternative economic plan for a post-Allende government, and was actually presented *to* the military on the day of the coup. But the plan was not decisive in shaping the Pinochet regime's early economic policy. Military officers, not economists, took the key economic positions at the outset of the regime. Most of the

[82] Juan Gabriel Valdes, Pinochet's Economists: The Chicago School of Economics in Chile, 16-17 (1996).
[83] In 1956, the University of Chicago, the Pontifical Catholic University of Chile and the predecessor of the U.S. Agency for International Development signed an agreement known as the Chile Project, under which more than 60 Chilean economists pursued graduate studies at the University of Chicago until 1964. The success of the program, both in terms of the performance of the students in Chicago and their influence upon their return to Chile, led to the program's extension. Over time, the group of Chicago-trained economists took up positions at local universities, in government, and at major firms. This group "formed a single community…sharing the same technical language, a rationalistic approach to problem solving and the eagerness to contribute, through their efforts, to creating a prosperous, fair and free society. Most of the economists are currently known—whether they like it or not—as Chicago Boys." Valdes, supra note 82, at 24 (quoting Rolf Luders). Not all of the important economists among this group were trained at the University of Chicago; some had degrees from Harvard and Columbia.

military were comfortable with the tradition of strong state intervention in the economy that had characterized prior governments. Indeed, the free market plan was actively opposed by a high-level committee of military officials formed to provide economic advice to Pinochet. Even some important private sector groups who supported the new military government were opposed, reflecting their attachment to the country's corporatist tradition and their own rents. Thus, the Brick was not initially greeted by the new Pinochet government with anything resembling evangelical zeal, let alone implemented in systematic fashion.

The government did not embark wholeheartedly on a free market economic plan until April of 1975. At that time, the country was in the midst of yet another serious recession. Milton Friedman made his famous visit to Chile to meet with Pinochet as his top advisors debated whether to use a gradual strategy or shock therapy to restore the economy. Pinochet was taken with Friedman's advice to pursue massive economic reforms at once. This decision had two major consequences: Pinochet took complete control over economic policy, and the Chicago Boys became his closest advisors.

Unlike the other senior military leaders, Pinochet was keenly attracted to the Chicago Boys and their ideas. There were several reasons for this affinity. First, Pinochet disliked the prevailing social climate in Chile in which power and status were perpetuated by family names and connections. Pinochet distrusted both business people and politicians, and the Chicago Boys were outsiders to both the traditional business circles and the political establishment. Second and relatedly, he was concerned about opposition from labor unions, trade associations and established business leaders. Free market reforms appeared to be a useful device for weakening the power of these groups by facilitating market entry by new domestic firms and foreign investors. In short, the pre-Pinochet regime's economic reforms had a political economy as well as an economic reform dimension. Market-oriented reform provided a response to the Olson problem.

Finally and perhaps most importantly, Pinochet's ambition was to reshape Chile's institutions and economy. He wanted his name to be linked to the transformation of the country, and he applied the strategic thinking of a military man to the accomplishment of that goal. The Chicago Boys neatly fit his strategy. They were a zealous team of technocrats with a logical and fully worked out plan of action. They had a strong sense of mission, but were not ambitious in conventional political terms; at least at the outset they, like Pinochet, were not rent seekers.

The ensuing process of economic reform can be divided into three distinct periods. In the first period of structural reform, lasting from 1973 to 1982, the basic foundation for a free market economy was laid. Price and wage controls were ended, SOEs were sold to private investors, financial markets were liberalized, the tax system was reformed, the foreign investment regime was restructured, trade protections were eliminated, and the social security system was privatized. In the second period, from 1982-1984, Chile experienced a severe recession and social unrest touched off by a financial crisis. The government intervened extensively in the financial system and reversed some of the prior reforms. Interest rate and exchange controls were re-introduced and fiscal spending increased. As the country recovered from the recession, a new wave of reforms was undertaken from 1985-1989. In this third period of reform, the government measures taken in response to the crisis were rolled back while free market reforms were extended into previously untouched areas. Most remaining SOEs were privatized. The central bank gained formal independence. Taxes and customs duties were reduced.

As important as Pinochet's policies themselves was the process by which they were formulated and implemented.[84] Economic reforms were undertaken through a streamlined governmental structure, in which Pinochet, as the president of the junta, and later as president of the country, exercised the executive power, while the junta (consisting of the commanders of the military branches as well as the police) was vested with the legislative power. A coordinator with the rank of minister and access to the president received reform proposals, accepted or rejected them, and determined when to forward them to the "legislature." Every year the ministries prepared a list of the main reforms they wished to have approved, and each minister was evaluated in large part on how effectively he had implemented the reforms. Technical analysis and evaluation of each reform was conducted by a planning office known as ODEPLAN. This office, staffed with Chicago Boy technocrats, effectively replaced the pre-existing economic bureaucracy.

This structure had enormous consequences. The political transaction costs of policy making were greatly reduced by the small number of actors. Policy implementation was facilitated by the concentration of authority in the president, which sidelined other governmental actors. Most importantly, this process insulated the policy-making organs from interest group pressure. Reforms were undertaken based on technical evaluation, without input from most social groups that would be affected by the

[84] See Chumacero et al., supra note 77, at 105.

new policies. Pinochet became an autocrat in economic as well as political terms.[85] The parallel to the Korea experience is striking. Despite radically different economic strategies, the political economy of the two regimes shared the feature of a shift in prior governments characterized by rent seeking alliances to governments committed to economic growth.

There was one exception to this closed process of economic policymaking. Under Pinochet, a new generation of entrepreneurs who shared the intellectual vision of the Chicago Boys emerged.[86] They understood the features of a free market economy and were confident of the opportunities available through radical market liberalization. Known as "the Piranhas," these entrepreneurs founded conglomerates active in finance, insurance and media. Unlike other private sector actors, they enjoyed access to the Chicago Boys engaged in economic policy making. Their privileged access to information and shared philosophical moorings with Pinochet's economists made them aggressive and highly successful investors in the first period of reforms. Their rapid expansion served as an important locomotive for Chile's growth in the first phase of economic reform. Here too there was a parallel to Korea's experience. Business groups favored by the regime were an important engine of growth.

This pattern of interaction between the public and private sector changed as a result of the economic crisis afflicting Chile from 1982-84, which threatened the stability of the Pinochet regime. The situation re-ignited political opposition, leading to mass demonstrations and the resurgence of political parties and labor union activism. To stem

[85] See Valdes, supra note 82, at 259.
[86] For example, the Cruzat-Larrain holding company was led by Manuel Cruzat, an economist with graduate training at the University of Chicago and Harvard, who participated in the preparation of El Ladrillo.

the crisis, the government intervened extensively in the financial sector. Ten banks accounting for 45% of the capital and reserves of the entire financial system were placed under direct government supervision or in receivership.[87] The Piranhas were criminally prosecuted and jailed. Pinochet removed the Chicago Boys from key positions in the government and replaced them with people more closely aligned with traditional business circles. The new players with access to the president shared the basic free market ideas of those they replaced, but they accepted a more active role for the government in the economy, and opened the policy making process to a wider spectrum of interests.

The change in personnel and policy making style, designed to neutralize threats to the regime by co-opting its opponents, led to a partial reversal of certain initial reforms, as noted above. But the move was strategic: once the economy recovered and political threats subsided, Pinochet returned to free market policies with renewed enthusiasm. The episode illustrates a consistent theme in economic policymaking under Pinochet: "reforms were carried out in bursts, whenever political opportunities arose."[88]

In summary, Pinochet eventually embraced free market reforms with a vengeance. But the choice was the result of a complex amalgam of considerations, having as much to do with strategic political calculation and personal ambition as with devotion to a particular economic philosophy. To a certain extent, free market reforms were chosen by default: laissez-faire was the only major approach to the economy that had not been tried with abysmal results in Chile's recent past.

But this raises our key question: Why did economic actors trust Pinochet's commitment to the new rules of the game? The centralization of political power in

[87] Valdes, supra note 82, at 263.
[88] Vittorio Corbo, Rolf Luders and Pablo Spiller, The Foundations of Successful Economic Reforms: The Case of Chile, unpublished working paper (1997), at 5.

Pinochet and his junta might have led to doubts about the longevity of the new economic policies: does one invest if future returns depend on the choices made by a small group of decision makers? As just noted, Pinochet demonstrated a high degree of opportunism in his approach to economy policy. Little stood in the way of policy reversals if political considerations required them.

To a much greater extent than in the case of the Park regime in Korea or China under Deng Xiaoping, the credibility of Pinochet's economic policies seems bound up in the prospects for political reform in Chile. In contrast to Korea and China, the authoritarian regime that spearheaded the economic transformation was an aberration in Chile's political history. Throughout the twentieth century, Chile had been governed by a constitution featuring separation of powers and regular elections among competing political parties dominated by rent-seeking elites. With the benefit of hindsight, we know that the authoritarian regime eventually gave way, beginning in 1989, to democratically elected governments that continued Pinochet's basic economic policies and institutions. The economy prospered, particularly in the "golden decade" from the late 1980s to late 1990s—precisely the moment of Chile's return to democracy. What is the link between this political transition and Chile's economic transformation?

The question is how current investors were assured that their future return would be protected. How this was accomplished is not immediately obvious. One might assume that the prospect of an eventual return to democracy in Chile following Pinochet's free market-oriented structural reforms would bring about a greater sense of certainty to private actors than would be the case in a country without a democratic tradition. Yet in the context of Chile's historical experience, the specter of a return to democracy may have *increased* uncertainty among economic actors, perhaps to an even greater extent than if the country had no democratic tradition. We have noted that Chile's pre-Pinochet political system was used as an extremely effective mechanism of rent seeking by groups that gained influence in the democratic process. The democratically elected Allende regime had attempted its own radical transformation of this economically disastrous tradition, including large-scale expropriation of private property and massive state intervention in the economy.[89] Many of the political leaders with the potential to be elected president in a post-Pinochet regime were staunch critics of free market policies. Economic growth depended on a future political economy, as opposed to an economic strategy, dramatically different from the dynamics of Chile's pre-Pinochet democracy.

Given these uncertainties, constitutional reforms undertaken by Pinochet appear to have been crucial in securing economic expectations during his regime, and beyond. In 1980, a new Constitution was approved by plebiscite. It sought to lock in the free market principles espoused by the regime, including property rights protections, freedom of choice in economic affairs, trade and financial openness, and a subsidiary role for the state in the economy. The Constitution's drafters used a variety of powerful measures, including the creation of a class of unelected senators, to make changing these economic principles extremely difficult.[90]

Political features of the new Constitution also probably contributed to the credibility of economic policy by bolstering the longevity of the regime while simultaneously limiting the range of substantive policy allowable to the Pinochet

[89] See Valdes, supra note 82, at 6-10, for an illuminating discussion of economic policy under Allende and Pinochet in the context of Chilean democracy.
[90] In balancing a shift of power toward non-elites (i.e., away from the military) with explicit constraints on how the transferred power could be exercised, the Chilean constitution tracks Acemoglu and Robinson's game theoretic model of a shift from autocracy toward democracy. Acemoglu & Robinson, supra note 43.

regime's successors. The Constitution fixed Pinochet's presidential term at eight years, and specified that at the end of that term the junta would nominate a candidate for a new six-year term, to be approved by plebiscite. If, as actually happened, the junta's nominee (obviously, Pinochet himself) was not approved, then open elections were required one year later. This structure meant that in 1980 when the Constitution was approved, Pinochet was guaranteed to remain in office for at least nine more years.[91] The combination of economic and political provisions in the Constitution was thus highly complementary—not because economic freedom was inextricably linked with political openness, but because growth-favoring economic principles were cemented in place and effectively de-coupled from political uncertainties, even in view of an eventual return to democracy. The result was a credible commitment to economic policies supporting growth that protected current investment against future policy changes.

The effectiveness of this constitutional design is confirmed by recent history. Although the political features of the Constitution were amended by the democratically elected governments that followed Pinochet, the economic provisions remain untouched to this day. Indeed, the first two post-Pinochet presidents, center-left Patricio Aylwin and Eduardo Frei, publicly declared that they would not alter the basic features of the existing economic model. As scholars of the Chilean experience argue, "[t]he endorsement of the development model by the first two democratically elected governments that followed the Pinochet regime increased the credibility of the reforms, and in this way reduced the risk of policy reversals. As a result, a quantum jump in investment and savings emerged."[92]

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[91] Chumacero et al. supra note 77, at 106.
[92] Vittorio Corbo, Rolf Luders and Pablo Spiller, The Foundations of Successful Economic Reforms: The Case of Chile, unpublished working paper (1997) at 10.

Foreign investment trends appear to support this line of analysis. One of Pinochet's first economic reforms was to aggressively open the country to international trade and capital flows. The restrictive Andean Pact framework was abandoned in favor of one anchored in non-discrimination and limitations on discretionary authority of state actors. A new foreign investment law was enacted in 1974. This statute (still in force) provides strong investor protections, particularly in relation to remittance of profits and safeguards against additional taxation. The law also establishes an administrative procedure for challenges to governmental decisions that violate the principle of non-discrimination, and permits foreign investors to challenge alleged violations by the government before a neutral tribunal in proceedings outside Chile. Rates of foreign investment increased immediately after the new statutory regime was put in place.[93] However, the truly significant jumps in foreign as well as domestic investment took place after democratic governments replaced the military junta in the early 1990s. For example, the investment rate in capital assets as a percentage of GDP increased from 20.8% in 1989 to 30.6% in 1995.

In the final analysis, both the transformation of the institutional framework and improvement in the political environment were crucial to the country's economic success in the 1990s. Chile's rapid growth in this decade is thus explained by a combination of favorable economic policies initiated by the Pinochet regime beginning in the mid-1970s and improvements in the political environment beginning in the late 1980s that supported

[93] From 1954-1973, the twenty years preceding the military government, foreign investment in Chile totaled US$1.5 billion. By contrast, in the first twelve years of the Pinochet regime, from 1974-1986, foreign investment totaled US$2.75 billion. Ricardo Zabala, Inversion Extranjera Directa en Chile: 1954-1896, Estudios Publicos No. 28 (1987).

commitment to those policies.[94] Put differently, the economic reforms were a necessary, but not sufficient, condition for the Chilean Miracle.[95] While Pinochet's reforms laid the foundation for Chile's transformation from a perennial economic basket case to a high performer, an overall institutional transformation, including a return to democratic governance, constrained in its ability to undermine economic reform, and provided the credibility essential to Chile's developmental success.

C. China

China obviously requires discussion in a work grappling with economic success under authoritarian regimes. The economy has grown at rates of 7-10 percent per year for the past three decades, raising millions out of poverty.[96] It led the world in growth rates of both GDP and per capita GDP over the period 1990-2007 and nicely weathered the recession beginning in 2008 that affected most of the world much more significantly.[97] China's growth has been largely investment-driven, with investment consuming about 40 percent of GDP.[98] Huge advances in productivity were achieved once strict central planning was abandoned in the late 1970s. Opening to foreign trade and investment, culminating with China's entry into the WTO in 2001, also provided an important engine of growth. By the early 1990s, China had become the second largest

[94] Esteban Jadresic and Roberto Zahler, Chile's Rapid Growth in the 1990s: Good Policies, Good Luck, or Political Change?, IMF Working Paper WP/00/153, 2000, at 28 (finding that "essentially all of the increase in productivity growth [in the 1990s as compared to the 1960s] can be attributed to the structural reforms" and "more than half of the increase in productivity in the 1990s [relative to the 1980s] can be attributed to the improvement in political rights."

[95] Corbo et al., supra note 88.

[96] The list of economic accomplishments since opening in 1978 include 200 million people lifted out of poverty, a four-fold increase in China's share of world GDP, and an almost 70% increase in grain production. Briefing China's Reforms: The Second Long March, The Economist, Dec. 13-19, 2008, at 30.

[97] Allen & Qian, supra note 10, at 7.

[98] China: A Study of Dynamic Growth, WRS-04-08, available at http://www.ers.usda.gov.

recipient of Foreign Direct Investment ("FDI") in the world (after the U.S.), and it has been the world's top destination for FDI since 2003.

Not only is China's growth the most spectacular of that under any authoritarian political regime, but it poses the most serious puzzles for development theorists. As a team of scholars recently noted, "[T]he experience of the reform era in China seems to refute the proposition that a necessary condition for growth is that the legal system provide secure property and contract rights."[99] China's experience also seems to confound the claim, which the Korean experience, among others, is often cited to support, that economic growth inexorably leads to political liberalization.[100]

In broad overview, China's growth can be divided into two quite distinct phases. In the first phase, covering the 1980s, growth was sparked by agricultural reform, rural entrepreneurship, and the transformation of local collectives into profit-oriented enterprises.[101] From the 1990s to the present, Chinese growth has been state led. Reforms in the second phase focused on improving the performance of state-owned or affiliated enterprises and the expansion of foreign direct investment. Laws were enacted to provide an infrastructure for the transformation of SOEs into corporate entities with outside investors, stock exchanges were developed in Shanghai and Shenzhen to create an alternative to bank finance, and provincial leaders were incentivized to lure foreign investment. At first, foreign capital to feed the investment boom was provided largely by

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[99] Donald C. Clarke, Peter Murrell, and Susan Whiting, The Role of Law in China's Economic Development, in Thomas Rawski & Loren Brandt ed., China's Great Economic Transformation (2008), at 375, __.

[100] Minxin Pei, China's Trapped Transition (2006). See infra Part VI.

[101] See Yasheng Huang, Capitalism with Chinese Characteristics (2008) (arguing that the "true" Chinese economic miracle of entrepreneurial capitalism occurred in the 1980s, as opposed to the state-led capitalism which followed).

ethnic Chinese investors, particular from Taiwan and Hong Kong. But by the mid-1990s, FDI inflows increased and diversified significantly.

Although each growth experience is unique—and certainly China's political system creates important differences from our two previous studies—a theoretical perspective focused on the problem of a government making credible commitments to economic reform and encouraging commercial performance highlights some significant similarities as well. We begin once again with the political commitment to growth--the necessary but not sufficient condition for developmental success. As IMF analysts have noted, "[i]n China, the political leadership imposed a vision for the path of growth and development of the country."[102] Articulation of this vision began with Deng Xiaoping's ascension to power in 1978 after the death of Mao. Deng's policies of economic opening were reaffirmed during his tour of the southern coastal regions in 1992. In the wake of the Tiananmen crackdown at the end of the 1980s, economic growth took on additional political salience. An implicit social pact was sealed between the Communist Party leadership and the Chinese public, under which freedom in the economic realm would be granted in return for tight controls on political activities and a complete ban on challenges to the one-party state. As in Park's South Korea, economic growth became the central legitimizing force of the regime.

As in our other country studies, however, the political leadership's commitment to growth cannot be the entire explanation for economic success.[103] As noted above, in

[102] See Wanda Tseng & Harm Zebregs, Foreign Direct Investment in China: Some Lessons for Other Countries, IMF Policy Discussion Paper PDP 02/3 (2002) at 21.
[103] We thus part company with scholars who argue that policies produce growth, and institutions come later, in response to demands from an emergent middle class. See Edward L. Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, Do Institutions Cause Growth:? 9 J. Econ. Growth 271 (2004); Development Piecemeal, The Economist, August 7, 2004.

many respects China's growth contract was even more incomplete than those of our other case studies. In contrast to Korea, at the dawn of its economic takeoff China had neither institutional memory nor an existing business elite to guide the economic path chosen by the government; to the contrary, it had the social chaos and economically disastrous polices of the Mao era. In contrast to Pinochet's Chile, as a matter of government ideology China remained ambivalent about the role of private property until long after development had begun in earnest. And in contrast to both Korea and Chile, China lacked even the rudiments of a legal system to support markets when Deng initiated his policies. The Cultural Revolution had bulldozed the legal infrastructure—there were no functional courts, no corporate or securities laws, no contract law to support private exchange. Many of these standard elements of legal infrastructure for economic activity were not enacted until the 1990s--well into the high growth era—and even then the laws were primarily designed to spur state sector reform, not to support private sector economic activity.[104]

Given this vacuum in formal institutions, how did the government manage the economic transition to large-scale global market activity? Though the concrete mechanisms varied over time, the Party embedded high-powered incentives for growth within its own organizational structures. Economic growth became the key metric by which performance was measured, and the gains from growth, while improving the lives of millions, were disproportionately distributed within the party/state apparatus itself or to close relatives and associates of senior Party members. We liken the arrangement in

[104] For example, the 1994 Company law's primary purpose was to create a framework for the re-organization of state owned enterprises into corporate entities. Previously, state owned enterprises functioned as legal entities that could act in their own name, but their governance and control structure within the state apparatus was ill-defined. By transforming these enterprises into corporations, control relations within the state-owned sector were streamlined.

overall function to a private equity firm, in which the managers of a highly leveraged investment pool of operating entities have high-powered incentives to grow the businesses in their portfolio, because they will keep a significant portion of the gains from growth.[105] And the Communist Party itself plays the role of the private equity general partner, whose own interests provide a powerful incentive to monitor those actually operating the business. The managers get rich if they do well, but are removed if they do not.[106] As one commentator puts it,

> The CCP has not only been the instigator of economic growth; its members have been the main beneficiaries of it….Above all, crony communism in China is *symbiotic*: it is based on the mutual benefits of both the party and government officials and the capitalists. Each side of the relationship benefits from the interaction and lacks clear incentives to change the rules of the game.[107]

And just as poor performance of the private equity general partner can be punished by investors withdrawing their capital at the end of the partnership's ten year term, so the Communist Party's role is hostage to economic performance; poor performance would threaten both the party leadership and, perhaps, the regime itself.

Because China's growth period has two very different phases, our account is divided into the early phase and the present phase. We focus in the early phase on the incentives and informal property rights protections operating at the local level, where growth first occurred. In the current phase, our focus shifts to informal practices to aid

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[105] Of course, high-powered incentives require complementary high powered monitoring mechanisms. See Paul Milgrom & John Roberts, Economic Organization and Management 221-28 (1992)(discussing correlation between incentive intensity and monitoring intensity). We can understand the tainted milk scandal in China as the result of mismatches between incentives and monitoring.

[106] Ronald J. Gilson & Charles Whitehead, Deconstructing Equity: Public Ownership, Agency Costs and Complete Capital Markets, 108 Col. L. Rev. 231 (2008), describes the incentive structure of the participants in a private equity limited partnership.

[107] Bruce J. Dickson, Wealth into Power: The Communist Party's Embrace of China's Private Sector 23-25 (2008).

quasi-privatization of state-owned enterprises, adaptive mechanisms for building regulatory infrastructure, and protection of foreign investors.

In 1980 China introduced a new fiscal system under which provinces were allowed to retain a large share of marginal increases in revenue, in effect giving local governments a "carried interest" in economic growth. Local governments, which faced serious budget constraints at the time, were motivated to expand sources of revenue by developing the local economy and fostering the growth of local enterprises. A new form of enterprise that developed under this fiscal system was the Township-Village enterprise (TVE), which "played the catalytic role in transforming the Chinese economy from a command economy to a market economy."[108] TVEs took different forms in different localities. Some TVEs were owned and managed by local governments, serving as subcontractors to SOEs. Others, the so-called "red hat" collectives, were essentially private firms ostensibly registered as collectives to avoid political problems. Whatever their form, the TVEs were critical to China's early growth. In the 1980s, TVEs produced 10 million nonagricultural jobs in the countryside.[109] By 1991, rural industry was producing 50% of total industrial output, equal to that of the state-owned sector.

TVEs prospered in part due to ideological resistance to private enterprise, but above all because of their fiscal importance to local governments. Rather than bleeding local enterprises under their control, local government officials had incentives to grow and take profits from TVEs to fund public services and subsidize less profitable sectors of the local economy, such as agriculture. Local governments helped secure financing for TVE formation and expansion by serving as guarantors, mobilizing funds through the use

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[108] Quoted in Dickson, supra note 108, at 47.
[109] Id.

of personal and professional connections, and by permitting the formation of semi-private credit institutions.

The importance of TVEs to local government revenues provided strong incentives to secure their property rights even in the absence of formal protections provided by the legal system. The incentives reduced the uncertainties facing private entrepreneurs by making the local government's commitment to growth credible. The local government commitment supported by TVE revenues was complemented by the personal incentives of local government officials. Local officials personally provided a form of protection of expected investment returns and contract facilitation in the local economy, particularly in regard to inter-jurisdictional business dealings. Private entrepreneurs from outside the locale used government officials in the host jurisdiction to serve as their "agent for contract enforcement."[110] For a fee (usually nonmonetary), the local official would influence or pressure the local contracting party to perform his commitment to the outsider. The initiative of officials to generate local economic activity took other forms as well. For example, in some cases local governments relaxed centrally imposed production quotas and devised formulas for sharing the gains achieved with local producers.

Well beyond the TVEs, post-Mao China has made widespread use of privileges awarded by the state to allow public bureaucracies to generate and keep revenue.[111] Monopolies, sale of public services, and for-profit spin-offs of public enterprises such as hospitals and schools are used to generate income throughout the bureaucratic hierarchy

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[110] Michael Trebilcock & Jing Leng, The Role of Formal Contract Law and Enforcement in Economic Development 92 Va. L. Rev. 1517, 1559 (2006).
[111] See Yuen Yuen Ang, Bureau-Contracting in China: Fusing Bureaucracy and Private Contracting (Or How Chinese Bureaucracies are Organized as Markets *and* Hierarchies), unpublished Ph.D. Dissertation, Stanford University (2009), at 9.

in China.[112] One scholar argues that many of the rules governing the internal affairs of the state and its lower level organs were designed precisely to promote administrative self-financing. From this perspective, the involvement of Chinese bureaucrats in business enterprise is not corruption, but implicit contracting – like that which is braided with formal contracting in private equity structures[113] – between the party-state and its agents designed to reduce budget pressures, distribute rewards to the ruling elite, and retain influence over an increasingly market oriented economy.[114]

The cadre evaluation system used by the Communist Party also contributed to a more secure business environment for TVEs and other enterprises. This system sets criteria for the performance—and hence the remuneration and promotion prospects—of local party cadres and government officials. Under the system, the most heavily weighted performance criteria relate to economic growth, tax revenue, and employment. Officials cannot maximize performance along these metrics unless local businesses are afforded considerable de facto protections of their investment returns.

In the second, state-led phase of China's economic growth, additional dynamics were at work in support of credible commitment to growth. We focus on two: the role of family members of senior party leaders in the transformation of state owned enterprises, and the expanded role of local-center relations, including jurisdictional competition and experimentation, in the creation of an adaptive regulatory environment for economic activities. These dynamics also contributed to the favorable foreign investment climate

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[112] Id. at 9-15.
[113] Ronald J. Gilson, Engineering a Venture Capital Market: Lessons from The American Experience, 55 Stan. L. Rev. 1067 (2003), describes the braiding of formal and informal contracts in the context of venture capital. Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 Colum. L. Rev. 431 (2009), and Gilson, Sabel & Scott, supra note 39, address braiding more generally.
[114] Ang, supra note 112, at 9-15.

that developed in the second phase of growth, despite the absence of a robust legal system.

As noted, the local, entrepreneurial emphasis of the 1980s gave way to a state-led growth model in the 1990s. Virtually all of China's most important firms, including its publicly listed firms, are connected to national or provincial state organs. To this day, most truly private firms in China are small, their business practices are opaque and informal, and "few have graduated beyond the initial founding stage in the life cycle of the firm. They are tightly controlled by the immediate family members of the founders and are lacking in professional management."[115] This feature of China's high growth sets it apart quite starkly from the Chilean and Korean cases. In those countries, while the growth effort was state coordinated, the governments relied overwhelmingly on private enterprise—family based corporate groups--to carry out their economic policies. As we will see, while the Chinese party-state has brought family members into its ranks, it has done so in novel fashion--by sharing ownership in government controlled entities.

Relying on the family as the basis for business relationships has a long history in China, as elsewhere when formal enforcement is not available.[116] In China, family oriented commercial activity has often operated outside the formal legal system. Franklin Allen and Jun Qian argue that China has avoided western-style corporations financed by dispersed investors because it "runs directly against the traditional Chinese model of keeping business 'within the family.'"[117] In the Qing Dynasty, local officials, families and merchant guilds played a key role in commercial dispute resolution. Even after the

[115] Huang, supra note 102, at 291-92.
[116] For example, Avner Grief's work on early Maghribi traders provides a detailed account of the earliest western manifestation of family ties substituting for legal rules. See Avner Greif, Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition, 83 Am. Econ. Rev. 83 (1993).
[117] Allen & Qian, supra note 10, at 10.

emergence of Shanghai as an important international financial center at the turn of the twentieth century, foreign merchants, lacking local knowledge and connections, did business through Chinese middlemen and guarantors.[118]

Possibly echoing these historical practices, the Chinese Communist Party has essentially installed a clan-based enterprise system at the top of the economic structure. An implicit rule in China is that the children of high-ranking party officials hold positions of authority in major enterprises. The actors in this process are the so-called "Princelings" (*taizi dang*)—children of influential party members, whose nickname derives from their quasi-hereditary privileges.[119] The term is also used more broadly to refer to those closely connected to the Party establishment through marriage or collegial relationships. The Princelings operate outside of established hierarchies, wielding influence beyond and across the separate spheres of politics, business and the military.

The links between party officials and business managers are extensive, and lucrative. In 2002, *Newsweek* reported on an internal Party survey indicating that 98 percent of senior officials had relatives in significant business or government positions.[120] Another internal Party document indicates that 90 percent of the millionaires in China are children of high-ranking officials.[121] There are many examples of Princeling involvement in nationally important businesses, including Zhu Yunlai, the son of former Premier Zhu Rongji, the Chairman of China International Capital Corporation, China's first investment bank. Jiang Mianheng, son of former Premier Jiang Zemin, has

[118] Id. Allen & Qian's analysis illustrates the path dependency at the core of most accounts. The serendipity of history – family as a substitute for government – transmutes into culture over time, which in turn becomes part of the toolbox available to subsequent reformers.
[119] See To the Money Born, Financial Times, March 30, 2010 (examining the role of the Princelings in China's private equity industry).
[120] Melinda Liu, China's Princeling Problem, Newsweek, Nov. 25, 2002.
[121] Dickson, supra note 108, at 23.

extensive ties to the information technology sector. Rong Zhijian, son of former vice-president Rong Yiren, is chairman of CITIC, the huge state-owned investment company. Chen Yuan, the chairman of China Development Bank, is the son of Chen Yun, one of the founding figures of the Peoples Republic of China. Close relatives of the current leadership also hold high positions in business. President Hu Jintao's son, Hu Haifeng, until recently headed a state-controlled company called Nuctech, one of the world's leading suppliers of security inspection systems. Premier Wen Jiabao's son is chairman of New Horizon Capital, a domestic private equity fund, and his son-in-law appears on Forbes' 2005 list of The 400 Richest Chinese. The pattern is repeated at the local level, where family members of provincial leaders often hold significant business positions in business ventures and enterprises. And it extends to Chinese firms with foreign operations. One study finds that "a remarkably high proportion of the managers of major Chinese TNCs [transnational corporations] are relatives of senior government officials."[122]

The extensive linkages between Princelings and business has generated, in the words of one commentator, a process of "elite privatization," leading to "clan control of China's private enterprises."[123] The term elite privatization seems a particularly apt characterization of China's movement of assets out of exclusively state hands, and presents a variation on the oligarchic form of privatization experienced in Russia about the same time. Consider this description of the process:

> The richest people in China are the relatives of the very top officials who used their position to pass laws transforming state-owned industries into

[122] X.L. Ding, Informal Privatization through Internationalization: The Rise of Nomenklatura Capitalism in China's Offshore Businesses, 30 British J. Pol. Sci. 121 (2000). See To the Money Born, Financial Times, March 30, 2010, p.9.
[123] Liu Xiaobo, China's Robber Barons, China Rights Forum, No. 2, (2003), at 73, 75.

> stockholding companies, and then appointed family members as managers. In this way the children of top party officials--China's new "princelings"--took over China's most strategic and profitable industries: banking, transportation, power generation, natural resources, media and weapons. Once in management positions, they got loans from government-controlled banks, acquired foreign partners and listed their companies on Hong Kong or New York stock exchanges to raise more capital.[124]

The rise of Princeling-linked firms coincided with the central government's policy of developing national champions with internationally competitive capabilities and brand recognition. The government thus had strong incentives to provide Princeling enterprises with special access and protection at both the national and local levels. Moreover, these benefits extend beyond the Princeling enterprises themselves, which sometimes act essentially as general contractors, to a broad network of their subcontractors and affiliates, which receive protection from the government in their role as suppliers to key national firms. The process of elite privatization thus created firms that blur the line between state and private enterprise—firms that enjoy unique advantages in navigating the difficult terrain of the Chinese bureaucracy. While they are (understandably) a frequent target of criticism by Chinese commentators,[125] the Princelings thus appear to have played a role in securing informal property rights and coordination of investment in a rising China. The children of high party leaders, as beneficiaries of economic reform, in effect act as Williamsonian hostages – the children of the monarch placed in the hands of those who need to rely upon the monarch.[126] And while children of the political elite have played prominent and lucrative roles in states that failed to develop, the difference in China is the Party's commitment to growth; like the operating executives of the

[124] Peter Kwong, China's Neoliberal Dynasty, The Nation, October 2, 2006.
[125] At least, Chinese commentators with the temerity to broach the topic publicly. The Princelings are off limits as a subject of coverage in the state-controlled media.
[126] Oliver E. Williamson, Credible Commitments: Using Hostages to Support Exchange, 73 Am. Econ. Rev. 519 (1983).

portfolio companies of a private equity fund, wealth for the Princelings depended on the firms' economic performance rather than the naked diversion of revenues.

Princelings have also played a role in providing a more secure regulatory and political environment for FDI in China. Foreign investors may be attracted to Princeling firms because of the special advantages and protections they enjoy. The government, when considering action that might infringe the interests of foreign investors, must consider the consequences for Princelings as well. For example, Morgan Stanley was an initial investor in CICC, the investment bank headed by Zhu Yunlai, the son of the former premier. Although Morgan Stanley was eventually eliminated from CICC's core management circle, its investment has never been jeopardized. Morgan Stanley's links to the Party establishment through Zhu provide it with a rough form of protection against arbitrary or detrimental government action. Moreover, echoing practices from an earlier era, Princelings also commonly serve as middlemen with respect to inbound foreign investments. In such a role, they use their connections to senior party officials to advance and protect the interests of foreign clients.[127]

We do not wish to overstate the role of the Princelings in China's economic success. China's economy is vast and diverse, and this phenomenon is not an explanatory silver bullet. Moreover, even the economic interests of the Princelings are subject to infringement to meet higher political and economic imperatives of the Party. If Princeling firms do not perform, they are punished. The point is that familial and other close connections between political and business leaders in China have cemented a developmental alliance that partially compensates for holes in legal infrastructure and

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[127] See Wanda Tseng & Harm Zebregs, Foreign Direct Investment in China: Some Lessons for Other Countries, IMF Policy Discussion Paper PDP 02/3 (2002) at 18 (local partners help foreign investors in China overcome bureaucratic obstacles posed by their lack of connections).

participatory policy making processes, in effect discharging the functions of pre-existing business elites in Korea and Chile during their economic transformations that China lacked.

Apart from the Princeling phenomenon, the Communist Party has adroitly co-opted private entrepreneurs into its membership ranks. After overcoming fierce ideological resistance, in 2002 the Party began not only to tolerate party membership by entrepreneurs, but to actively court them. Once again, an implicit bargain for growth is at the heart of the strategy: "This integration of wealth and power is in the mutual interest of both communist officials and private entrepreneurs. The officials rely on the private sector to produce growth, jobs, and tax revenue, and the entrepreneurs rely on contacts within the party to improve their business prospects."[128]

A final, distinctive feature of China's economic rise we highlight here is the unusual adaptive capacity demonstrated by the country's regulatory infrastructure. The roots of China's "adaptive authoritarianism" are complex and not yet fully understood, but they seem traceable in significant measure to the related roles that jurisdictional competition and experimentation have played in the formation of a market-supportive regulatory environment.[129]

As the discussion to this point has indicated, post-reform China has developed into a quasi-federal economic system. Strict central planning gave way to a system in which control rights over economic inputs and allocation were decentralized and aligned by means of incentives – in our terms, the ineffective efforts at complete contracting

[128] Dickson, supra note 108, at 99.
[129] See, e.g., Sebastian Heilmann, Policy Experimentation in China's Rise, 43 Stud. in Comp. Int'l Development 1 (2008). On the political implications of the Chinese Communist Party's adaptability in moving from "utopia to development," see Andrew J. Nathan, Authoritarian Resilience, 14 J. Democ. 6 (2003).

through central planning gave way to incomplete contracting where ultimate control is buttressed by incentive alignment, a pattern that we have called a private equity model. As we noted above, local and lower ranking officials throughout the bureaucratic hierarchy were given substantial leeway in attracting and engaging in economic activity, and allowed, formally through revenue sharing or informally through the ability to act as middlemen, to share in economic success. As well, career advancement was tied to measures of economic success. This system produced incentives to innovate in regulatory and policy matters as well as economic activities. The central government, ironically following Brandeis' rendition of a central virtue of a federal system[130] with more intensity than its country of origin, uses local-level experimentation as a policy laboratory. Successful pilot tests at the local level are generalized, coordinated, and scaled up by central government authorities in a process that one commentator calls "experimentation under hierarchy."[131] This process involves a "purposeful and coordinated activity geared to producing novel policy options that are injected into official policymaking and then replicated on a larger scale, or even formally incorporated into national law."[132]

Jurisdictional competition is an important feature of the process of local experimentation. The special economic zones where China's economic liberalization began are one obvious example. Another is the development of the stock exchanges. Although the exchanges are under the control of the central government and lack significant formal enforcement authority of their own, they have experimented

[130] New State Ice Co. Liebmann, 285 U.S. 262, 311, (1932) (Brandeis, J., dissenting).
[131] Heilmann, supra note 130 at 5.
[132] Id. at 3. Heilmann argues that "[t]he pursuit of extensive, continuous, and loosely institutionalized experimentation can be understood as a crucial policy mechanism in China's economic rise." Id. at 4.

significantly with informal enforcement mechanisms such as shaming sanctions against listed companies. Their regulatory strategies appear to be shaped by their competition with each other, and Hong Kong, for listings.[133]

Returning to our private equity metaphor for the nature of China's implicit contract for development, the Chinese pattern of decentralized experimentation and innovation bears close resemblance to key features of the venture capital model as practiced in the United States. Venture capital finance responds to the problems of low trust and high information asymmetry that would otherwise severely limit the growth of start-up firms. Founders understand that meeting performance goals is necessary to obtain future rounds of financing on favorable terms. Venture capitalists evaluate innovation at an early stage and make predictions about the scalability of small-scale, localized success stories, but without formal commitment to provide further funding to the project.[134] In the corporate venture capital model, established firms invest in start-ups as a vehicle for experimenting outside organizational boundaries to promote trend spotting, to recognize future capability needs and to acquire skills and technology.[135] Established firms dispatch agents to observe and shape the experimental learning processes in their local context (the start-up firm) with the intent of internalizing useful insights. The Chinese process of "experimentation under hierarchy" mimics these key features. Local learning and innovation take place under the patronage of senior officials.

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[133] Benjamin L. Liebman & Curtis J. Milhaupt, Reputational Sanctions in China's Securities Market, 108 Colum. L. Rev. 929 (2008).

[134] See Gilson, supra note 114, at 1070-76 (explaining the function of staged financing in venture capital financing).

[135] Thomas Keil, Erkko Autio, & Gerard George, Corporate Venture Capital, Disembodied Experimentation and Capability Development, J. Management Stud. 1475 (2008). Other examples of the use by established firms of the capabilities of smaller earlier stage firms are described in Ronald J. Gilson, Locating Innovation: The Endogeneity of Technology, Organizational Structure and Financial Contracting, 110 Col. L. Rev. 885 (2010).

The staged replication and scaling applied in the Chinese context are similar to patterns of finance in the venture capital industry, where projects are funded in stages and scaled up only after they have proven successful at the experimental stage.

We began this overview of China by noting the challenge its growth poses for the conventional wisdom that rule of law – formal judicially oriented contract enforcement – is essential to economic development. One of us has argued elsewhere that China's "growth without law" can be exaggerated, in that law may have played important roles in enhancing the credibility of government policy and signaling the trajectory of the government's reform policies to market actors.[136] Whether or not law played a role in China's economic takeoff, it appears that important features of China's institutional apparatus today are becoming more regularized and law-oriented.[137] Statutes and regulations to govern economic activity have been enacted or revised at a feverish pace over the past decade. Some government agencies, such as the CSRC, overseer of the securities market and industry, have matured into sophisticated and well intentioned regulators. Even some government organs that lack legal authority, such as the stock exchanges, have creatively attempted to carve out for themselves a regulatory role designed to improve corporate practices.[138] Huge obstacles remain, of course. Effective enforcement lags behind the enactment of legislation and regulations. The competence and neutrality of the courts cannot be assumed. And political considerations remain above the law. But a creeping legalism is under way. Allen and Qian persuasively argue that non-formal techniques may suffice to trigger and sustain the initial stages of

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[136] Curtis J. Milhaupt & Katharnina Pistor, Law and Capitalism: What Corporate Crises Reveal About Legal Systems and Economic Development Around the World (2008).

[137] On China's gradual legalism, see Randall Peerenboom, China's Long March Toward Rule of Law (2002).

[138] Liebman & Milhaupt, supra note 143.

economic growth.[139] They do not address, however, the extent to which non-formal techniques will scale as China's internal market grows to supplement the export driven sector.

IV. Comparative Analysis

What lessons might be drawn from a side-by-side comparison of the three countries' growth experiences under authoritarian political rule? Our hypothesis is that credible commitment to growth is the key contribution of an economically benevolent autocracy—more important than other variables such as institutional formalism or development strategy that are often the focus of attention. Consistent with this hypothesis, our comparison reveals a high degree of variance in the mix of development strategies used by the political leadership, as well as in the character of the institutions used to carry out the growth-oriented policies, but a striking similarity in the *function* performed by the institutions that emerged under the economically benevolent regimes we surveyed.

The three countries in our study pursued radically different developmental strategies. As we noted in our sketch above, the Pinochet regime ordered the "Washington Consensus" menu of reforms long before it had been given a name. Chile followed a standard free market approach to growth, featuring openness in trade and investment, financial liberalization, and elimination of wage and price controls. By contrast, South Korea pursued what has come to be thought of as the standard "Asian" growth model, featuring a heavy export orientation, nurturing of strategic industries such as ship building and chemicals, the pervasive use of directed credit, financial controls, and protection of domestic industries. Although China has also relied heavily on exports

[139] Allen & Qian, supra note 10.

as an engine of growth, it departed from the South Korean developmental path in two key respects. First, in contrast to the Korean government's reliance on private firms to carry out its growth agenda, virtually all major Chinese firms are state owned or affiliated, although even these state participants are highly incentivized.[140] Second, the Chinese economy is considerably more open to foreign investment and trade than has been the case in other developing economies in Asia.[141] The takeaway point from this aspect of our comparison seems clear: national economic transformations are possible under a wide range of developmental strategies.[142]

These substantial variations in developmental strategy are matched by large differences in the character of institutions in the three countries. Chile stands out for its use of legal protections to anchor the authoritarian regime's economic policies. While, as we noted above, the legislative process under the Pinochet regime lacked features associated with rule-of-law states, such as checks and balances or access for private participation, the regime was quite meticulous about grounding its economic policies in formal law. This practice reflected a long culture of legalism in Chile.[143] Although the junta's primary motivation for adopting the Constitution of 1980 was settlement of intra-military conflict,[144] the Constitution also accomplished a high priority task of the regime: securing its economic policies well into the future, even in the event of political change in Chile. These constitutional protections for economic freedoms appear to have

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[140] In South Korea, the banking industry was nationalized from the early 1960s through the late 1970s, but most other key firms were privately owned.

[141] To cite just one example, China is the world's largest recipient of foreign direct investment.

[142] This point is subject, of course, to the limits of rationality and the existence of complementarities between the developmental strategy being pursued and the regional or global economies.

[143] See J. Esteban Motes & Tomas Vial, The Role of Constitution-Building Processes in Democratization, working paper 2005 at 5-7 (one reason Pinochet adopted the 1980 constitution was the "legalistic culture that had permeated Chile since the mid-nineteenth century").

[144] See Robert Barros, Constitutionalism and Dictatorship: Pinochet, the Junta, and the 1980 Constitution (2002).

significantly bolstered confidence in the stability of Chile's long-term economic trajectory; economic growth accelerated after the center-left successors to Pinochet as president committed to the constitution's protection of the regime's economic policy. As we saw, legislation was also central to the creation of a successful foreign investment regime.

In contrast to the culture of legalism in Chile, the Park regime carried out its policies in reliance on a pre-existing culture of bureaucratic competence and administrative informality. Similar to Japan in its developmental phase, bureaucratic fiat was the central mechanism used to regulate the Korean economy, despite the relatively developed nature of the formal legal system. Government-orchestrated trade associations and informal contacts between the economic bureaucrats and the private sector served as the principal conduits for policy formation, implementation and monitoring, backed up by the government's power.

China's approach to economic institutions is something of a hybrid of the Chilean and Korean approaches. The complex bureaucratic and political landscape remains the supreme feature of economic administration. Much regulatory activity is informal, yet legalism is on the rise. Laws and regulations have proliferated in recent years, and have become an important, if still unevenly applied, element in the process of economic governance. Thus, just as a variety of developmental strategies can be effective, our study suggests that a variety of institutional approaches can effectuate those strategies.

Despite these differences, our country narratives reveal some striking similarities. First, all three studies feature a political regime with a preference for national economic development over the accumulation of personal wealth. However deficient Pinochet, Park, and Deng may have been along other important dimensions of governance—and there is a great deal to criticize in terms of human rights and civil liberties—they remained relatively free of corrupting influences and pursued policies that raised the standard of living for many of their citizens. In striking contrast to most authoritarian rulers (and some democratic ones), they did not use political power to pursue personal wealth, although China's Princeling phenomenon straddles the line between the use of family members to facilitate contracting[145] and corruption.[146]

Understanding at a deep level why the political leaders in our study made this choice is well beyond our ambitions here, but several observations shed light on the question. One of us has suggested that it is analytically helpful to distinguish between pecuniary and nonpecuniary private benefits of control in comparative corporate governance,[147] and this taxonomy also appears apt in *political* governance. Economic success under authoritarian regimes seems to come about in the rare cases in which an autocrat seeks Great Man status through developmental transformation, in effect choosing non-pecuniary over pecuniary private benefits of control. But as illustrated by the widely varied motivations of Pinochet, Park, and Deng, the preference for status as a leader over personal wealth accumulation appears highly idiosyncratic and is likely to be heavily influenced by historical circumstance.[148] Pinochet was intellectually attracted to Milton Friedman's ideas; but he also saw that radical free market reforms would

[145] See Greif, supra note 117 and Gilson, supra note 2 (discussing use of family as an organizational design tool).
[146] At least not on the scale that vast political power would permit (e.g. Marcos in the Philippines).
[147] See Ronald J. Gilson, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 Harv. L. Rev. 1641 (2006) (distinguishing pecuniary and nonpecuniary private benefits of control in the context of controlling shareholders).
[148] There is a large literature on whether leaders are "born or made," but the most convincing view is that leadership is a product of both individual traits and historical circumstance. See Ronald A. Heifetz, Leadership Without Easy Answers 16-23 (1994); Joseph S. Nye, Jr. , The Powers to Lead 3-7 (2008).

undermine his political enemies and weaken the Chilean social traditions he despised. Deng Xiaoping was a socialist, but he had a front row seat on the disastrous consequences of Mao's collectivist economic policies. He was influenced by the rise of the Asian Tiger economies, which achieved both domestic prosperity and international respect through development. Deng reinforced his commitment to economic development in the early 1990s in part to salvage his legacy after worldwide condemnation of his regime's brutal response to the Tiananmen protests.[149] Park Chung-Hee, as noted above, was captivated by Japan's corporatist path to industrialization. He saw how a neighboring Asian country could rise from the ashes of war by marshalling a national will to develop, building on a tradition of bureaucratic competence to forge a partnership between the state and private entrepreneurial resources.

From this small sample, we might at least conclude that the preference for nonpecuniary private benefits of political control is not closely linked to political or economic ideology. As noted, historical circumstances seem important. One common element in these radically different national histories is that the political leader who initiated economic transformation emerged when his country was either in the midst of, or just emerging from, a period of (real or perceived) existential chaos—the rise of socialism and anarchy under Allende, civil war in Korea, and the Cultural Revolution in China.[150] The transformational success of these political leaders may be due in part to a national readiness to be *led*, at least by important elements of the population, in order to

[149] Bao Pu, Epilogue, in Prisoner of the State: The Secret Journal of Zhao Ziyang 280 (2009) ("If the hard-line victory ended up killing economic reform as well, Deng would face the terrible prospect of being known as the butcher of Tiananmen who defended an indefensible regime and squandered the prestige he had gained earlier from the nation's economic progress.")
[150] This is consistent with Mancur Olson's contention that drastic national upheavals break up distributional coalitions, allowing formation of new economic and social orders. Olson, supra note 35.

restore national pride or at least social order, and because of the compelling attraction of growth to the well being of the population.

Although the commitment of the three leaders to economic development was highly idiosyncratic, the crucial point is that the ability of their regimes to credibly commit to growth was not. Stated differently, the preference of the decision maker for growth was a necessary, but not sufficient, condition for the country's developmental success. Other commentators have suggested otherwise. For example, scholars have recently argued that constraints on political leaders are not essential to growth. In this way, autocracies produce growth by improving human and physical capital; institutions subsequently improve as countries grow richer.[151] They write, "In many poor countries, security [of property rights and constraints on government] comes from policy choices made by dictators. The economic success of East Asia in the post war era, and of China most recently, has been a consequence of good-for-growth dictators, not of institutions constraining them."[152] Similarly, Fareed Zakaria argues that the success of what he calls "liberal authoritarian regimes" in South Korea, China, Chile and elsewhere are the result of "shrewd choices for the long term."[153]

In critical respects, our theoretical perspective and country studies are not consistent with this view. What makes an autocracy "good for growth" is not simply the leader's preference for growth or his shrewd choices about developmental strategy. The economically benevolent autocracy is able to assure economic actors that pledges to pursue growth and to allow economic actors to keep the fruits of their investments will be honored. Credible commitment is secured by institutions (whether formal or informal),

[151] See Glaeser, La Porta, Lopez-de-Silanes, & Shleifer, supra note 104, at 298.
[152] Id.
[153] Fareed Zakaria, The Future of Freedom: Illiberal Democracy at Home and Abroad 251 (2003).

not individual preferences. This fundamental conclusion of our study is shared by scholars who focused, not on twentieth century dictators, but on the kings of medieval Europe.[154]

The ruler's need to credibly commit to growth may help explain the presence of business groups in each of our case studies. One way to secure credible commitment is through repeated interactions. We have seen how each of the regimes in our studies worked with—and indeed, helped create – business groups as partners in the development project. Long-term interaction between the political regime and the business groups secured the growth pact, because both parties derived benefits from the arrangement. The business groups provided the hydraulics for the regime's growth strategy. Close connections between state economic planners and key business people reduced information asymmetries about both policy direction and effects, and the resulting increase in switching costs reduced the risk of future policy changes that would threaten investment returns.

These effects were very pronounced in the case of Chile, where the new international conglomerates were the only groups with access to the regime's economic policy making process. Privileged access gave the conglomerates a key role in policy formation and allowed them to expand aggressively, raising GDP growth in the process.[155] Coordination, communication and enforcement costs for all three regimes were reduced by the regime's ability to work with a limited number of business people,

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[154] Avner Greif, Paul Milgrom & Barry Weingast, Coordination, Commitment, and Enforcement: The Case of the Merchant Guild, 102 J. Pol. Econ. 745 (1994) (stressing the importance of institutionalized commitment to security of property rights of merchants, rather than mere promises by rulers, to the expansion of trade in medieval Europe).

[155] Eduardo Silva, Business Elites and the State in Chile, in Business and the State in Developing Countries, in Maxfield & Schneider, supra note 59, at 152, 159-60.

which, in turn, facilitated accountability – responsibility for performance was clear. Growth, then, provided profits for business and legitimacy for both the political regime and the economic elites. Government support helped scale up relational networks and adapt them to global markets. Business groups thus help governments address the incomplete contracting problem inherent in economic development.

Consistent with this perspective, Tarun Khanna and Yishay Yafey have suggested that business groups allow the state to orchestrate a "big push" into several sectors simultaneously.[156] Business groups thus merit a more positive, or at least more holistic, evaluation than they typically receive in the economics literature, where they are generally viewed solely through the lens of agency costs as a means to organize private activity, rather than as governmentally supported agents of economic policy.[157]

The policy debate about institutions for economic growth, as well as scholarly explanations for economic success, have centered on the required *character* of those institutions. Formal institutions (i.e. laws and regulations) are often said to be more predictable, transparent and open than informal institutions, and thus more conducive to economic development. The World Bank, drawing intellectual support from a decade of economics literature, has consistently stressed the importance of a formal legal system to economic development.[158] Particularly in the wake of the Asian financial crisis in 1997-98, the World Bank and other financial institutions promoted changes in corporate, securities, and bankruptcy laws based on a standard menu of statutory provisions thought to improve investor and creditor protections and thereby produce positive economic

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[156] See Tarun Khanna & Yishay Yafeh, Business Groups in Emerging Markets: Paragons or Parasites, ECGI Working Paper No. 92/2005 (surveying literature on groups from variety of analytical perspectives).
[157] Khanna and Yafeh, supra note 157, reach a similar conclusion.
[158] See Frank Upham, Mythmaking in the Rule of Law Orthodoxy, Carnegie Endowment for International Peace Working Paper (2002), at 9-10 (citing a variety of World Bank literature).

outcomes. But China's dramatic growth under weak formal legal institutions posed a serious challenge to this conceptual approach to law and development. To resolve the conflict, a revisionist argument has emerged, attributing China's dramatic economic growth to its *lack* of Western-style formal legal institutions.[159] As previously discussed, Franklin Allen and Jun Qian argue that China has succeeded by *avoiding* formal law--which in their view is rigid and susceptible to interest group capture--and relying instead on reputational and other informal devices to support economic activity.[160]

Our analysis, however, indicates that the formalist's emphasis on the *character* of institutions for economic development is misplaced, as is the informalist's ignoring of the state's central role in facilitating what are in fact only quasi-informal arrangements. High growth autocracies have used a range of formal and informal mechanisms to support their developmental policies with the state playing a central role across the entire continuum. As scholars dating back to Max Weber have recognized, nondemocratic regimes can make their decisions "calculable" by effectively bounding the range of possible outcomes, even in the absence of formal constraints on the state.[161] It is the function, not the character, of an institution that matters for purposes of economic development.[162] Perhaps the signature lesson to be taken from China's growth is that,

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[159] Allen & Qian, supra note 10.
[160] Allen and Qian fail to recognize that the coercive power of the state is the backdrop for much of the activity in China they characterize as "informal."
[161] See Gerard Alexander, Institutionalized Uncertainty, The Rule of Law, and Democratic Stability, 35 Comp. Pol. Stud. 1145, 1156 (2002).
[162] The World Bank came to this conclusion after a decade of law reform efforts stressing institutional character rather than function. See World Bank, Economic Growth in the 1990s: Lessons from a Decade of Reform 26 (2006).

given political will to develop and existing endowments, pragmatism and creativity in devising credible commitment devices will be richly rewarded.[163]

V. Lessons for Developing Democracies: Creating Credible Commitment

We examined the experiences of three economically successful autocracies with the goal, not of extolling the performance of authoritarian governments, but to identify the techniques they used to credibly commit to building the institutions that support economic growth. The diversity of the three experiences teaches one important lesson. Just as a country's development strategy will be in part a path dependent function of its history, so too will the mechanisms available to an emerging democracy for securing credible commitments be dependent upon its circumstances. As suggested previously, this counsels against identifying best practices and in favor of functional efforts to solve a problem common to developing countries regardless of form; the problem, but not always the responses, will generalize.[164]

Shifting focus from the character of institutions for growth to their *function* suggests that a range of novel institutional approaches is worthy of consideration by developing democracies. Such democracies plainly lack the capacity to directly commit to growth that was available to economically benevolent autocracies. But credible commitment can be secured in a variety of ways that may not require the governmental power available to an autocracy, including repeated dealings, changing the party with decision-making authority, and enforceable contracts.[165] Seeking to provide several illustrations rather than a catalogue, we discuss a few concrete examples of how

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[163] A Chinese economist draws a similar lesson, attributing his country's economic success in part to the pragmatic emphasis placed by policymakers on "institutional efficacy" over "institutional purity." See Yang Yao, The Disinterested Government and Economic Growth in China, working paper (2009).
[164] See supra notes 162-163 and accompanying text.
[165] See Acemoglu & Robinson, supra note 43, at 134-35.

pragmatically creative institutions may sustain credible commitment to development even in a weak democracy. And here our own biases emerge quite clearly. We prefer seeing an existing democracy develop to the hope that development will lead an autocracy to democratize.

As we noted above, part of the problem facing countries seeking to make the transition from relational to arm's length commerce is that credible formal enforcement institutions are difficult to establish and impossible to establish quickly, while informal government support for relational enforcement is difficult to make credible in the face of elite resistance – a characteristic of developing democracies. But what one country cannot do for itself, a group of countries may accomplish collectively. As our earlier discussion of Russian corporate law reform showed, it is relatively easy to adopt commercially supportive substantive law but absolutely difficult to establish effective formal enforcement. At least part of the difficulty is that in a dispute involving a local elite, the Olson problem presents a significant barrier. Even though the costs to the economy of favoring the local interest are significant, the elite's influence nonetheless may subvert the enforcement process.[166] The intuition is that when it is not possible for a state to credibly commit itself to take hard decisions, the enforcement mechanism can be credibly outsourced through multinational effort. In precisely those circumstances when an individual state would flinch at taking enforcement action, its counterparties could be counted upon to act.

[166] The Vietnam's Supreme Court's decision that a foreign holder of a letter of credit from a Vietnamese bank that supported an import by a Vietnamese debtor had to first pursue the debtor in Vietnamese courts before seeking payment from the bank is an example of the Olson problem in this context. See Letter of Credit Case Stopped, Financial Times, June 11, 1998, at 6; Jonathan Birchall, EU Warns Vietnam Over Letters of Credit, Financial Times, Aug. 11, 1998, at 6.

For example, one way of pre-committing the state to more evenhanded enforcement by reducing the influence of the local elite is through the establishment of a regional commercial court.[167] Such a court, created for example by a group of countries in East Asia or South America in connection with regional trade pacts, could be composed of judges drawn from the region with expertise in business and finance. Firms could contractually bind themselves to resolve disputes with trading partners or investors in the regional court. While a country would still have to enforce a judgment of the regional court, the failure to do so would invite retaliation by the country's largest trading partners, thereby allowing even an emerging democracy to make a credible pre-commitment to the unbiased enforcement of arm's length contracting associated with the next step in economic development.[168]

Other imaginative examples of achieving credible commitment to politically unbiased enforcement of investor protections in the absence of highly functional state-supplied legal procedures can be found in Taiwan and South Korea, both very successful economies with authoritarian political histories. In Taiwan, the Securities Futures Institute (SFI) is an ingenious mechanism for overcoming collective action problems and political uncertainties in shareholder litigation.[169] The SFI is a nonprofit organization established by, but separate from, the Taiwanese securities regulatory authority. The organization purchases one trading unit of shares of each publicly listed company in Taiwan, giving it standing to bring suit as a shareholder. By delegating enforcement to

[167] Jens Dammann and Henry Hansmann note that regional courts merit more extensive consideration as a response to weak national judicial systems. See Dammann & Hansmann, supra note 38, at 56.
[168] Avinesh Dixit, Governance Activities and Economic Activity, 99 Am. Econ. Rev. 1 (2009), discusses the mechanisms of multilateral enforcement.
[169] See Curtis J. Milhaupt, Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia, 29 Yale J. Int'l L. 169 (2004).

an organization politically one step removed from the government, the state makes political protection of elites more difficult and thereby provides support to the establishment of effective capital markets, an area where there is considerable empirical evidence that informal enforcement is not a substitute for formal enforcement.[170] In Korea, a private NGO without links to the government has successfully performed a similar function.[171] Developing creative partnerships between the government and nonprofit organizations to encourage better enforcement of law seems a good deal more feasible than transplanting procedural mechanisms such as class action litigation from other countries onto a judicial process that is still far from mature.

Finally, the potential of creative contracts as commitment devices is underscored by three examples from South America: two from Chile and one from Brazil. The first Chilean example is the state's contractual promises to foreign investors to maintain consistent tax policies and arbitrate disputes in a neutral forum. The second is the 1980 Constitution's explicit enumeration of economic freedoms, protected by high barriers to amendment. The Brazilian example involves a private effort to improve by contract the effectiveness of the capital market and, correspondingly, to lower the cost of equity capital by providing greater shareholder protection. A barrier to capital market reform in Brazil was that it threatened the existing elite who controlled much of the economy through high voting shares, and who had the power to block legislative reform. The solution was the Sao Paulo Stock Exchange's initiative to give private companies the

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[170] The link between formal enforcement and economic growth is most clear in connection with financial development. See, e.g., Ross Levine et. al. Financial Intermediation and Growth: Causality and Causes, 46 J. Monetary Econ. 31 (2000); Thorsten Beck & Ross Levine, Legal Institutions and financial Development, in Handbook of New Institutional Economics 251 (Claude Menard & Mary M. Shirley eds., 2005); Katharina Pistor et. al, Law and Finance in Transition Economies, 8 Econ. Transition 325 (2000); Kenneth W. Dam The Law-Growth Nexus: The Rule of Law and Economic Development (2006).
[171] Milhaupt, supra note 170.

option to list on a new stock exchange segment that provides much greater shareholder protection, including a requirement of one-vote per share, without altering the rules governing companies controlled by the existing elite and therefore without directly threatening their position.[172]

Our goal here is not to exhaustively survey the variety of ways in which an emerging democracy can credibly commit to growth-inducing enforcement through formal or informal means. Rather, it is to highlight the potential for multilateral government enforcement and informal private initiative to provide a level of credible commitment necessary to support growth. Clarifying the task – to develop techniques that allow developing democracies to credibly ties their hands – will allow scholars and policy analysts to generate a range of "Commitment Apps" that will facilitate economic development by developing democracies.

VI. Economic Development and Political Liberalization

Up to this point, our focus has been on the potential linkage between political regime type and the creation of institutions conducive to economic development. We conclude with some thoughts on a corollary question of major contemporary significance, particularly in relation to China: Does economic development lead to political liberalization?[173]

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[172] Gilson, Hansmann & Pargendlar, supra note 34.

[173] We try to avoid framing the discussion in terms of "democracy" and "democratization" because these terms have a tendency to freeze the discussion around a fixed set of attributes such as elections and separation of powers. Instead, we take a functional approach, viewing a democracy simply as a government that is responsive, and responsible, to the people, regardless of the mechanism. In social science literature, democracy is generally defined as a "political system in which positions of top power are obtained through open, competitive, periodic elections." Andrew Nathan, China's Political Trajectory: What Are the Chinese Saying?, in China's Changing Political Landscape: Prospects for Democracy 25, 27 (Cheng Li ed., 2008). For present purposes we are more ecumenical, leaving the debate over what counts as"democracy" to others. Cheibub, Ghandi & Vreeland, supra note 5, address in detail the difficulty of defining democracy and dictatorship, and show that simple definitions provide better empirical predictions

While we earlier saw that the empirical evidence does not support the proposition that democracy leads to economic growth,[174] an influential literature argues that economic growth leads inexorably to political liberalization. The developmental experiences of Chile and East Asian countries are widely cited in support of this view.[175] Francis Fukuyama, for example, claims that

> The desire to live in a liberal democracy is not initially nearly as widespread as the desire for development. In fact, there are many authoritarian regimes like today's China and Singapore, or Chile under General Pinochet that have been able to develop and modernize quite successfully. However, there is a strong correlation between successful economic development and the growth of democratic institutions, something originally noted by the great sociologist Seymour Martin Lipset.[176]

Similarly, Fareed Zakaria writes that "the best-consolidated democracies in Latin America and East Asia—Chile, South Korea, and Taiwan—were for a long while ruled by military juntas. In East Asia, as in western Europe, liberalizing autocracies laid the groundwork for stable liberal democracies."[177]

The argument for a tight nexus between economic development and political liberalization is founded on a compelling chain of logic. Though the details vary, the argument generally proceeds along the following lines: Economic development requires a rule of law to protect property rights. Development generates a middle class and spawns complex organizations interposed between the state and the people. An increasingly comfortable middle class eventually seeks greater freedom of choice in the realms of politics and civil society, while the formation of new organizations causes power to

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than carefully nuanced continuums. Steven Haber, Authoritarian Government, in Oxford Handbook of Political Economy 693 (Barry Weingast & Donald Wittman eds., 2006), focuses on an operational definition of authoritarian governments.

174 See supra note 11 and accompanying text.

175 See, e.g., Zakaria, supra note 154 at 69-72.

176 Francis Fukuyama, The End of History and the Last Man 344 (2006 ed.)

177 Zakaria, supra note 154, at 56.

devolve from the state. In turn, the state becomes increasingly rule bound as it negotiates with these new, competing sources of authority. Political liberalization follows, sometimes only unintentionally, as protections expand from property rights to human rights and freedoms.[178]

Although internally consistent and compelling, there are problems with this argument that become apparent when it is examined in light of actual experience. Consider the common reference to Chile as an illustration of the nexus. Chileans themselves disagree markedly on the contribution of Pinochet's economic policies to political liberalization.[179] Some commentators—typically past supporters of the Pinochet regime--argue that the economic technocrats, understanding the relationship between economic freedom and political liberty, essentially engineered Chile's return to democracy.[180] Zakaria echoes a version of this claim in asserting that, despite his failings, "Pinochet did eventually lead his country to liberal democracy."[181] A distinct and more nuanced argument is that the modernizing impact of the spread of market ideas in Chile provided the main thrust for the country's major advance in development, which fostered a *new* democracy, distinct from the one that existed prior to Pinochet.[182] This debate is instructive, because it highlights an essential fact of Chile's experience typically overlooked by proponents of the development-to-democracy theory: Chile had a democratic form of government—albeit a weak one—for most of the twentieth century, and *returned* to democracy following a comparatively brief interruption of military dictatorship. As such, Chile's experience is hardly a close fit for countries such as China,

[178] Id. at 45-58.
[179] See Valdes, supra note 82, at 258-10.
[180] Id. at 258.
[181] Zakaria, supra note 154 at 95.
[182] Id. at 260-61.

which – again, putting aside labels -- have never experienced a government that is responsive and responsible to the people. Moreover, the sequence between development and the return to democracy in Chile is far from linear. In fact, Chile's economy enjoyed its best performance in the 1990s--*after* Pinochet's departure. As we noted in our country sketch, the prospect of a return to democracy may have actually diminished confidence in Chile's developmental trajectory, at least until it became apparent that the democratically elected leaders following Pinochet would retain the economic stance self-consciously enshrined in the 1980 constitution, which had as its goal constraining the future actions of someone other than Pinochet.[183]

If the Chilean case does not clearly support the conventional wisdom about the causal link between economic growth and democratization, what does it signify? The most notable feature of the story is Pinochet's adherence to legal norms to pursue his economic development agenda. This legalist bent eventually eroded his regime's grip on political power. As commentators note,

> Soon after crushing the elected government of Salvador Allende in 1973, the Chilean regime found it necessary to create a stable and predictable set of legal norms. In so doing the regime sought to provide private market actors a degree of predictability and hence a more favorable environment for investment. The legal structure that the Pinochet regime erected eventually contributed decisively to the regime's demise: it couldn't get out of its commitment to subject its rule to popular referendum or thwart the institutions it had set up to make the referendum fair, and it lost the referendum.[184]

[183] For example, one commentator states, "[A]s late as 1987 and 1988, Chilean business leaders expressed 'concern …about something as fundamental as property rights,' indicating 'the degree of uncertainty with which even relative optimists faced the transition to democracy.'" Gerard Alexander, 35 Comp. Pol. Stud. 1145, 1160 (2002) (quoting Bartell).

[184] Carles Boix & Susan C. Stokes, Endogenous Democratization, unpublished working paper, at 7 (2002) (summarizing Barros's argument).

The Chilean case is thus a significant rule of law story, illustrating the importance of formal institutional constraints on political power to the eventual emergence or re-emergence of democracy. It demonstrates the inherent difficulty political leaders face in seeking to confine the rule of law to the economic realm. This conclusion sits comfortably with the conventional wisdom, but recall that Pinochet was adhering to a climate of legalism and democratic politics that predated his regime by nearly a century. Again, we see the importance of path dependency and a country's own history. Pinochet's decision to subject his regime to a plebiscite (to be sure, an election he believed he could not lose), was almost certainly influenced by his country's unique history. In short, while the implications of Chile's experience for the relationship between development and democracy are worthy of deep study, casual references to Chile's experience in support of a direct progression from economic growth to political liberalization are highly misleading, especially when made in the context of contemporary China.

Now let us turn now to South Korea—another country often cited by proponents of the development-to-democracy progression. In broad outline, the country's recent historical experience does fit the conventional wisdom quite well. As South Korea developed economically under authoritarian rule, the population grew increasingly restive, demanding greater social and political freedoms. An active civil society grew up quite literally out of street protests against the series of military governments which followed Park Chung-Hee. In 1987, military strong man Chun Doo-hwan acceded to protests and allowed his successor to be chosen in a direct presidential election.[185] In 1992, three decades after Park seized power, a free election produced the first civilian

[185] Two opposition candidates split the vote, leading to the election of the military's favored candidate.

president, Kim Young-sam. Three democratically elected presidents have followed, and South Korea receives high rankings for political rights and civil liberties.[186]

This extremely impressive national accomplishment merits the attention it has received. But this is only a partial narrative of the link between economic development and political life in South Korea. At least from the perspective of how Korea's recent history may be relevant to China, there is more to the story.

As we have seen, the conventional wisdom stresses the emergence of complex organizations in the process of development as a counter weight to state power. In each of our country studies, and most dramatically in Korea, we have seen that economic development generated a particular form of new, complex organization interposed between the government and the market—the business group, whether privately owned or state controlled. The political implications of business groups as engines of economic growth have not been carefully considered in exploring the democratization hypothesis. In particular, the rise of huge, globally competitive multinational firms embedded in networks of affiliations, including familial connections, with the Communist Party and state organs has not been fully analyzed in the debate over China's potential for political liberalization. This is where the other side of Korea's story may be highly relevant.

South Korea's developmental path has created a decades-long tension between the economic benefits of *chaebol*-led growth and the political influence of the business groups. The tension is perhaps inherent in the *chaebol* themselves, which are creatures of the political environment: "the rapid growth of the *chaebol* is generally considered to be the result of political decisions by the government – the result of governmental favoritism

[186] See, e.g., Freedom House, Freedom in the World—South Korea (2008), available at www.freedomhouse.org/inc/content/pubs/fiw/inc_country_detail.cfm?year=2008&country=7425&pdf (giving South Korea the highest score for political rights and the second highest score for civil liberties.)

through interlocking relations between politicians or government policy-makers and entrepreneurs."[187] Although the authoritarian military rulers who created these linkages have been replaced by democratically elected civilians, the business groups forged out of the growth alliance in the 1960s remain as powerful actors in the Korean political economy. Many of the *chaebol* today are enormous organizations with far flung operations and globally recognized brand names (think of Samsung Electronics or Hyundai Motors, for example). Consistent with the development-to-democracy hypothesis, they do indeed possess considerable power vis-à-vis the state. But their influence is not necessarily conducive to a more transparent and accountable political process or more robust rule of law. The *chaebol* have been linked to a long series of political scandals, and they have staunchly resisted legal reforms that would diminish their power.[188] As Freedom House reports, "Despite the overall health of the South Korean political system, bribery, influence peddling, and extortion by officials have not been eradicated from politics, business and everyday life."[189] No government subsequent to Park's has succeeded in distancing itself from *chaebol* influence or reducing the impact of these groups in the political economy. Rather, they "have all reneged on early promises of taming the *chaebol* and have pursued pro-growth strategies relying on the *chaebol* as the engines of that growth."[190]

Historical experience suggests that key entrepreneurs present at the critical moment in a country's national economic transformation often take on larger-than-life

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[187] Jwa, supra note 66, at 65.

[188] See Martin Fackler, Recriminations and Regrets Follow Suicide of Former South Korean President, New York Times, May 24 (2009). (reporting that "cycle of corruption [ ] has plagued South Korean presidents," who maintain links with *chaebol*).

[189] Freedom House, Freedom in the World—South Korea (2008), available at www.freedomhouse.org/inc/content/pubs/fiw/inc_country_detail.cfm?year=2008&country=7425&pdf.

[190] Fields, supra note 59, at 128.

roles in the realm of political governance as well. This was as true of the nineteenth century robber barons in the United States as of the Russian oligarchs who emerged in the 1990s. The accumulation of wealth and influence of economic elites, coupled with the state's fear of cutting off the engine of development by reining in their operations, can significantly complicate the process of political and legal reform. Globalization serves to magnify this process, as the scope of state influence wanes vis-à-vis businesses that are highly mobile across national boundaries.[191]

This perspective may bear on the prospect of political liberalization in China. To a far greater extent than was ever the case in South Korea, key political and economic actors are bound up together in a dense network of interlocking relationships. From the Princeling phenomenon to the promotion standards operating in the system of economic quasi-federalism, and from pervasive state ownership of large enterprises to portfolio investment by the country's sovereign wealth fund, the political regime has thoroughly embedded itself in the high powered incentive structures that fuel the country's economic growth. At least in the realm of globally competitive or potentially competitive firms, Communist China is indivisible from Corporate China.

A political economy of this sort has few parallels in history.[192] To the extent historical parallels can be conjured up, they do not provide grounds for optimism about China's prospects for political liberalization.[193] As of this writing, the extensive linkages

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[191] At first blush, Russia's crackdown on the oligarchs in recent years may appear to contradict this assertion. But the oligarchs have been beaten down by undemocratic rulers in a country without a well established rule of law. Law was instead used as a pretext for dismantling sources of power that competed with an authoritarian state. See Milhaupt & Pistor, supra note 137, at 149-169 (discussing the "re-nationalization" of Yukos by Putin through ostensible use of bankruptcy and tax laws).
[192] Present-day Singapore arguably comes closest, though its diminutive size makes direct comparisons problematic.
[193] Late nineteenth century Germany and pre-World War II Japan come to mind as imperfect, but suggestive historical parallels.

between the Party and the largest firms in the economy, while beneficial for domestic growth and global expansion, have not had a salutary effect on either corporate governance nor on Governance with a capital G. To the contrary, corruption and non-transparency have been exported by the overseas operations of state-linked firms.[194] Particularly in light of South Korea's experience with the *chaebol*, it is fair to ask whether China's future political liberalization is imperiled by precisely the mechanisms that have been devised to develop economically.[195]

China to date provides a vivid illustration—in contrast to Chile--of the way economic growth-promoting constraints may strengthen, rather than undermine, the political survival of the regime.[196] Many commentators, economists in particular, simply equate institutions with "constraints on government,"[197] without recognizing that governments often constrain the exercise of their authority selectively and strategically. Our study shows that national economic transformation can be achieved with a variety of institutions whose creation and effectiveness are not uniquely tied to a rule of law and political accountability as conventionally understood. If this analysis is correct, China's rise may similarly challenge the conventional wisdom about the effects of economic development on the emergence of a liberal political order.

[194] In Namibia, for example, low interest loans from China were used to purchase $55 million in cargo scanners from a state-controlled company called Nuctech, run by President Hu Jintao's son. Namibian anti-corruption investigators allege that Nuctech paid $4.2 million in kickbacks which were split between a Namibian government official and Nuctech's Chinese representative in southern Africa. China has stonewalled Namibia's attempts to investigate, and censored reporting of the issue domestically. Sharon LaFraniere & John Grobler, China Spreads Aid in Africa, with a Catch, New York Times, Sept. 22, 2009, at A1.

[195] Though reached by a very different analytical path, our conclusion is consistent with that of China scholar Minxin Pei, who argues that China's process of political liberalization is "trapped" by the developmental autocracy's economic strategy of coercion, cooptation and adaptation. Pei, supra note 100.

[196] As one commentator notes, "Institutional constraints upon supreme power are not necessarily incompatible with authoritarianism…. [A] dictatorship can institute legal limits on its own exercise of political power and still remain free from democratic processes of selection." Robert Barros, Constitutionalism and Dictatorship: Pinochet, the Junta, and the 1980 Constitution 324 (2002).

[197] See, e.g., Glaeser et al. supra note 104.

At the very least, the collective nature of China's autocracy, with its institutionalized succession processes, suggests that if political liberalization is to occur over the medium term, it will be brought about principally through intra-Party reforms rather than bottom-up expression of aspirations for political freedom. This is likely to have a profoundly constraining effect on the nature of the transition process and the post-transition economic structures. As we have stressed, political succession raises credibility problems, as economic actors worry about the new regime's adoption of policies that will devalue existing investments and discourage new ones. This is where Chile's experience with democratic transition may actually be most instructive for China. Recall Pinochet's 1980 Constitution, which contained modest political reforms coupled with iron-clad protections for the existing economic order. Similarly, the Chinese case predicts liberalization through gradual formalization of democratic elements within the Party, coupled with hard-to-change rules relating to the economy.[198] Under a system of intra-Party political reform, Princelings and other entrepreneurs with close ties to the Party, together with key state-affiliated enterprises, will likely continue to serve as important commitment devices in market transactions. While the role of the legal system in protecting economic expectations may continue to grow, it is unlikely to supplant the preeminent role of the government in informally encouraging contractual performance in support of development.

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[198] Note that such a process is consistent with the disavowal of Western-style separation of powers for China, which the current leadership makes with some regularity. See Nathan, supra note 174 (arguing that "democracy" carries a very different meaning to Chinese leaders than to Westerners). A Western-style separation of powers could be viewed by Party leaders as precisely the type of political system at risk of interest group capture or policy gridlock that would threaten continued development. This is not to argue that China's current political system is free from interest group capture, corruption, and many other ills. It is simply to emphasize the likely role that concern for continued development will play in constraining political reform in China.