

## **Politics and Economics**

### *Shifting the balance towards openness*

**Andrew Puddephatt**

There is a widespread consensus that transparency and accountability are essential underpinning of good governance and that this, in turn, is a pre condition for tackling poverty and inequality and achieving the Millennium Development Goals (MDGs). There are also widespread assumptions that transparency and accountability of public administration is necessary for sustainable economic development (for example the work of Amartya Sen in the 1990s that highlighted the development cost of secrecy).

One of the primary obstacles to transparency and accountability is what is often known as an asymmetry of information in that governments and public officials tend to know much more than citizens and hold onto information as a source of power. It is widely assumed that if public officials monopolize information about development programmes, corruption and maladministration will thrive. In the famous phrase “sunshine is the best disinfectant”. Notwithstanding the history secrecy of governments, in recent years there has been a substantial move towards greater openness with over 50 countries adopting access to information laws of some kind. This seems to be tied to the wave of democratization that followed the political events of the end of the 1980s and early 1990s. However, this momentum has now stalled and in many parts of the world democracy, and transparency, appears to be in retreat. The growing power of authoritarian societies such as Russia and China and their apparent determination to promote different approaches to those of open societies (such as the Russian ”sovereign democracy) is a particular challenge.

If progress is to be made we will need a more rigorous analysis of what might be termed the *politics of policy* in this field. Policy making in the real world is rarely shaped by rational, objective considerations. Any form of constitution making is most likely to be shaped by the “tectonic plates of power”. These tectonic plates will include structural factors such as the level of socio-economic development, the strength and weakness of particular institutions, the type of political system (parliamentary or presidential) and its stability, the perceived self interest of political actors, specific national and regional histories and cultures, the wider international dimension and contingent factors of both



- 8) What is the role of external agencies in these processes, including external donors, internal agencies such as the World Bank and foundations, and international NGOs such as the Carter Center.
- 9) Do we have sufficient independent data to arrive at definitive conclusions? Is more research needed – if so what kind?

At the conclusion of our workshop we will pr



## **Group One**

### **Politics and Economy: shifting the balance toward openness**

#### **List of Participants**

*Facilitator: Andrew Puddephatt*

*Rapporteur: Zachary Bookman*

Rodolfo Aldea

Joanne Archibald

Tom Blanton

Diego Garcia-Sayan

Olivia Grange

Juan Pablo Guerrero

CR Hibbs

Stephen Kay

Huguette Labelle

Firoze Manji

Juan Pablo Olmedo

Javier Ponce Cevallos

Rakesh Rajani

Miguel Rivadeneira

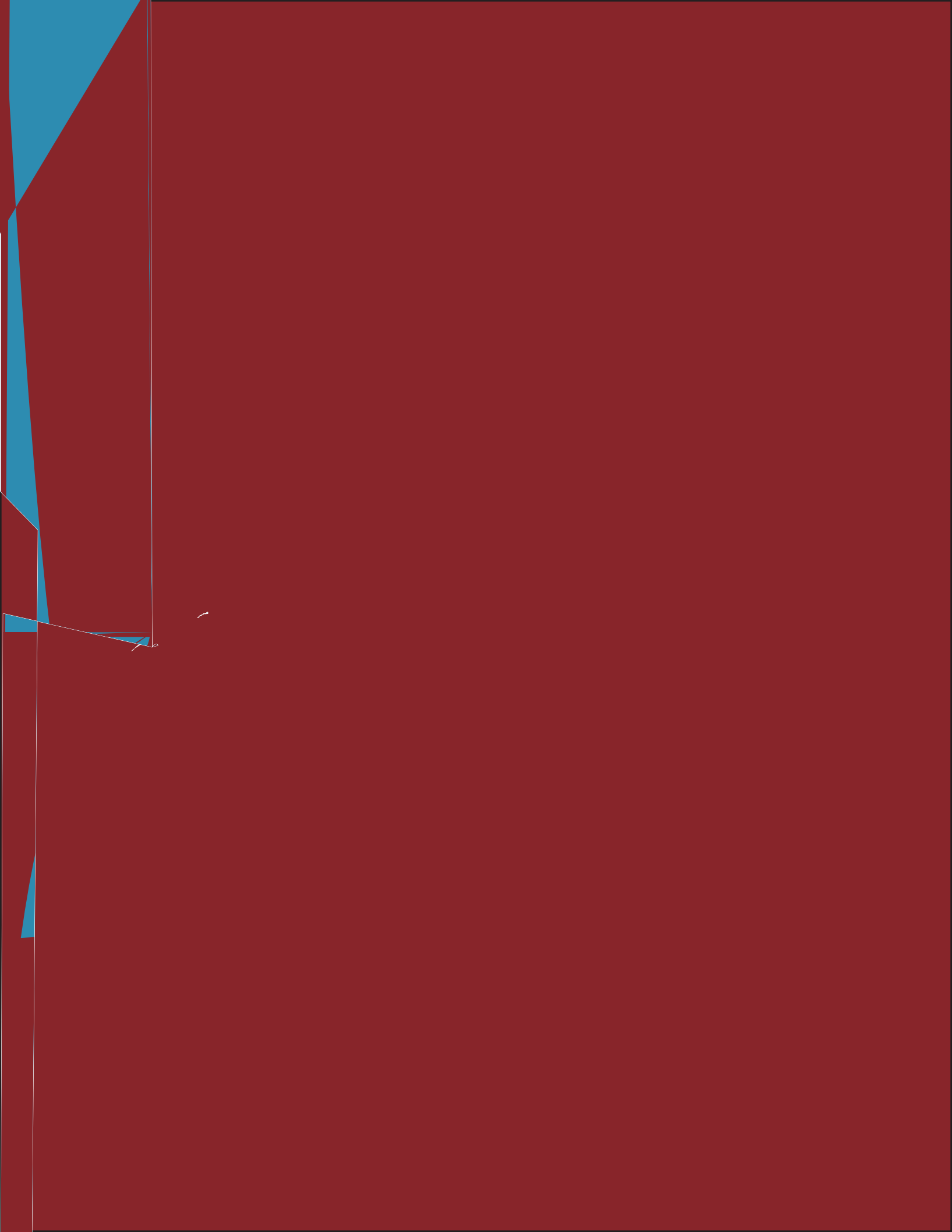
Alasdair Roberts

Rick Snell

Nardi Suvo

Min Tang

Vladimir Villegas



# **The Political Economy of Transparency: What Makes Disclosure Policies Effective?**

**Archon Fung  
David Weil  
Mary Graham  
Elena Fagotto**

Archon Fung, Mary Graham and David Weil are co-Directors of the Transparency Policy Project at the A. Alfred Taubman Center for state and Local Government, John F. Kennedy School of Government. Archon Fung is Assistant Professor of Public Policy at Harvard University's John F. Kennedy School of Government. Mary Graham is a Fellow at the John F. Kennedy School of Government and a Visiting Fellow at the Brookings Institution in Washington, D.C. David Weil is Associate Professor of Economics at Boston University and a Research Fellow at the Taubman Center for State and Local Government. Elena Fagotto is the senior Research Assistant for the Project.

This is the twelfth paper in a series dedicated to understanding innovation in the public sector. The Roy and Lila Ash Institute for Democratic Governance and Innovation fosters excellence in government around the world in order to generate and strengthen democracy. Through its research, publications, curriculum support, global network, and awards program, the Ash Institute explores critical issues in democratic practice and effective governance. By engaging a broad, global community in which knowledge is shared, by generating and supporting research and curriculum materials, and by highlighting exemplary government programs, the Institute serves as a catalyst for successfully addressing many of the world's most pressing concerns and, in turn, improving the lives of its citizens.

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## **I. Introduction**

Transparency systems hav

*by deliberative democratic processes.* Legislative, regulatory, and judicial processes provide government- mandated transparency systems with legitimacy and accountability.

Los Angeles County's restaurant grading system, adopted in 1997, provides a simple example of how legislated transparency can improve public health. Restaurants are required to display in their windows government grades of A, B, or C. The grades reflect restaurants' scores on an inspector's 100-point checklist that includes points off for rodent droppings, twice-served food, lapses in employee hand washing, and so on. Policy makers hope that customers will change their dining choices by selecting restaurants with higher grades, creating market incentives for those with low grades to improve their hygiene.

Early research suggests that this grading system has been highly effective. Researchers have found significant revenue increases for restaurants with high grades and revenue decreases for C-graded restaurants. They also have found measurable increases in restaurant hygiene in Los Angeles County and a consequent significant drop in hospitalizations due to food-related illnesses. Overall, more informed choices by consumers appear to have improved hygiene practices, rewarded restaurants with good grades, and generated economic incentives that stimulated a new kind of competition among restaurants (Jin and Leslie, 2003). This transparency system illustrates



makes it harder to ma

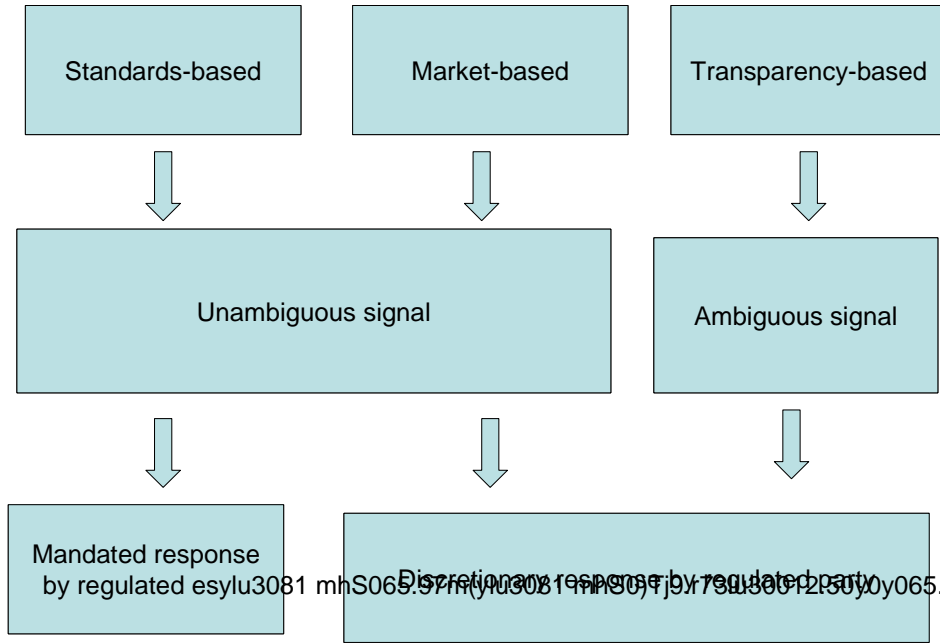
mechanisms, transparency systems may also be effective on balance while producing some unintended effects. For example, toxic pollution disclosure has led manufacturers to reduce their overall releases of harmful chemicals even though some may have substituted unlisted but perhaps more toxic chemicals and others have made only "paper" changes in estimating techniques or definitions. Likewise, financial disclosure has contributed to efficient investment choices and improved corporate governance even though some companies have created "off-balance-sheet" entities to inflate reported profits. Nutritional labeling has encouraged food companies to create brand extensions of healthy products but sometimes labels have also led dieters to buy "low fat" 993.27121 6.98 368.rk j10

*embedded in organizations' decision-making processes.* Assuming that information is accurate, this double-sided embeddedness becomes the most important condition for transparency systems' effectiveness. This finding suggests the importance of asking at the outset what information consumers or business managers want and how these users and disclosers make and alter the choices that public officials hope to influence. Since the way that individuals and organizations act varies widely, this finding further suggests that transparency systems need to be tailored to take account of the cult911 0 0 1911 0Tz7.r 8e4751

Then, in the 1960s, the emerging idea that the public had a “right to know” whatever information had accumulated in government files helped lay the foundation for the wider use of transparency systems.<sup>1</sup> Union demands for information about workplace hazards and citizen groups’ demands for information about toxic risks inspired local “right to know” laws (Baram, 1984; Ashford and Caldart, 1985; Hadden,

These differences between standard-based, market-based, and transparency-based regulatory systems are captured in Figure 1 below:

**Figure 1: Signals and Responses under Three Types of Regulation**





improves services is, therefore, anything but automatic. Whether and how new information is used to further public objectives depends upon whether and how it is incorporated into complex chains of comprehension, action, and response.

In transparency systems, those chains of action and response have two primary actors: those who potentially use new information produced by transparency policies to improve their choices; and those who are compelled by public policies to provide that information and whose behavior policy makers hope to change. These information *users* and *disclosers* are typically connected in a general action cycle that has six main parts:

**Figure 2: Transparency Action Cycle**

(1) transparency system

#### **IV. Information Embeddedness and User Decisions**

The fundamental feature of transparency systems is that they release information into the public domain by compelling corporations or other organizations to disclose information about their activities that they would not otherwise provide. The action cycle described in Figure 2 places information users as first movers in the sequence of actions and reactions.<sup>5</sup> Users of transparency systems have diverse interests. They may include consumers, voters, employees, suburbanites, inner city residents, competitors, organizations representing businesses or consumer interests, legislators, government agencies, and regulators themselves. They may be casually or intensely interested in new information. Their goals may or may not coincide with those of policy makers. The next analytic step is to explain what factors influence whether and how users incorporate such information into their actions.

Whether and how users respond to new information depends on how easily it fits into their accustomed ways of making choices. Cognitive psychologists and economists have provided insights into the bounded rationality of choice (e.g. Simon, 1982, 1997). They suggest that users of information act rationally to advance their various, usually self-interested, ends. However, because they have limited time and cognitive energy, they do not seek out all of the information necessary to make optimal decisions. Instead, they seek out information to make decisions that are good enough, using time-tested rules of thumb.



information's perceived value in achieving users' goals; its compatibility with decision-making routines; and its comprehensibility.

First, information must have perceived *value* to users in significantly advancing their goals. Many transparency policies provide facts that can substantially reduce health and safety risks or otherwise improve important choices. Nutritional labeling, automobile rollover ratings, and restaurant hygiene rankings, for example, enable consumers to better act on their existing preferences for healthy food, safe cars, and clean restaurants. However, if consumers have few real choices or do not believe there is anything more they need to know, new information is likely to be ignored. Requirements that employers clearly label hazardous substances in their workplaces have had little impact in part

for their children are more likely to consider new information about school performance if it is sent home with re-enrollment forms.<sup>8</sup>

Compatibility in the timeliness of information must be situation-specific. When choice occurs in advance of action, information needs to be available when commitments are made, as when home purchase contracts precede possession and employment decisions precede start dates. When choice and action coincide, however, information at time

Simple formats and trusted intermediaries can influence whether new information is comprehensible. If policy makers combine complex auto road-test results and probabilities into simple 5-star rollover rankings, such results may be more accessible to buyers. If policy makers disclose information in technical formats, business or government agency representatives, journalists, and consumer groups may simplify them. Environm

core organizational goals. For private sector entities, core goals often include  
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Overall, the cost to disclosers of integrating information on user responses into management decisions must be sufficiently low to justify their efforts in relation to expected benefits, defined in their own terms. Disclosers may be m

public goal of nutritional labeling was to reduce risks of heart disease and cancer. Many shoppers' private goals, as it turned out, were to lose weight. When dieters focused on cutting calories but not saturated fats, they complicated the signal to disclosers who were considering whether or not to introduce products that were low in saturated fats. The public goal of so-called Megan's laws, which require disclosure of the place of residence of convicted sex offenders, was to enable community residents to avoid proximity to offenders or increase their watchfulness, if they believed that was necessary. However, some users employed the information to carry out vigilante attacks.

Disclosers'016 Tc76.959a

transparency. Environmental, safety, or

chemicals released into the air and water while community residents have specific concerns about reducing exposure to chemicals that cause cancer or serious neurological damage. When misunderstood information becomes embedded in disclosers' decision-making, it can create a systemic distortions that impede transparency effectiveness.

In summary, lack of congruence in goals and actions and misinterpretations of new information can reduce the effectiveness of transparency systems, even if information becomes embedded in routines. Sometimes such distortions mean that new information does more harm than good in terms of furthering specific public policies. These gaps between effect and effectiveness can be reduced by designing transparency policies that produce accurate and easily understood information. As a practical matter, however, many gaps become evident only after transparency systems have operated for some time and their action cycles can be evaluated. Mid-course corrections therefore become essential. Including architectural provisions that



Table 1 provides an overview of the eight transparency systems we studied. Table 2 provides our assessment of the degree to which new information becomes embedded in users' and disclosers' decision-making, summarizes intended and unintended effects, and summarizes the literature on each policy regarding its

States has developed the world's most exacting and most studied system of mandatory financial reporting.

The purposes of this transparency system have remained constant: to protect investors from hidden risks, provide them with needed information to make investment decisions, and improve corporate governance. As noted earlier, required information has become highly embedded in the decision processes of both users and corporations. Institutional and individual investors use key indicators from quarterly and annual reports to inform stock purchases and sales. Securities' analysts, brokers, financial advisors, and other intermediaries translate these reports into user-friendly data for clients. Internet-based systems customize information to suit the needs of investors and search-facilitating technologies improve its readability. Comparability and reliability are strengthened by detailed rules and interpretations issued by the federal Securities and Exchange Commission (SEC), by the conventions of highly trained accountants, by independent auditing, and by SEC enforcement. Company managers, in turn, have become accustomed to tracking investor responses to their financial disclosures as a routine practice and respond to perceived investor concerns.

While some economists have questioned the need for and effectiveness of a mandated financial reporting system (Stigler, 1964; Benston, 1973), a growing literature suggests that such reporting has been effective both in reducing investor risks and in improving corporate governance. Research suggests that financial reporting limits investors' risks by reducing investment errors and costs of identifying appropriate investment opportunities (Simon, 1989; Botosan, 1997) as well as by generally reducing information asymmetries between more and less sophisticated investors (Bushman and Smith, 2001; Greenstone et al., 2004). Research also concludes that public reporting reduces firms' cost of capital (Botosan, 1997) and attracts the attention of analysts who may then recommend the stocks for purchase (Lang and Lundholm, 1996).

The literature also suggests that reporting improves corporate governance by reducing information asymmetries between shareholders and managers, encouraging managerial di

adopted by Los Angeles County in 1997 requires managers to post in their windows government-determined letter grades, ranging from A to C, that reflect the results of hygiene inspections. Early research suggests that grades have become quickly embedded in customers' decision-making. Restaurant managers, in turn, have incorporated the changed choices of customers in their decisions about hygiene. Publicly posted hygiene grades reduce search costs for consumers and provide restaurants with competitive incentive to improve. Restaurant grades are available *when* users need them: at the time when they make a decision about entering an establishment. Grades are available *where* users need them: at the location where purchase of a meal will take place. And they are available 633633 will tak:



had established that over-consumption of saturated fats, sugar, and salt could increase risks of these illnesses. Congress intended new labels both to change shoppers' habits and to encourage co

due to faulty metrics, may not have improved public health. In 1986, in the aftermath of a chemical accident that killed more than 2000 people in Bhopal, India and reports of smaller accidents and near-misses in the United States, Congress required manufacturers to disclose annually how many pounds of toxic chemicals they released to the air, water, or land, chemical by chemical and factory by factory. Initially enacted as a public “right to know” me

companies to reduce toxic releases, in the form of stricter laws and regulations (Graham, 2002; Graham and Miller, 2001). Many targeted companies, especially those with national reputations to protect, made commitments to long-term reduction of toxic releases in response to the first shocking disclosures and took some specific actions to minimize such releases. The effectiveness of these actions in reducing toxic pollution remains uncertain. Researchers have found that some decreases reflected changes only in reporting procedures, that substituted chemicals were not necessarily less polluting (Graham and Miller, 2001).

quality of required safety training has varied widely from workplace to workplace. Small workplaces often lacked the capacity to interpret chemical information and provide employees with sufficient training (GAO, 1992).

Exercising broad discretion permitted by regulators, employers have produced information sheets that vary widely in quality, detail, and technical vocabulary. Research on the quality of data sheets has shown that only 51% of analyzed sheets were partially accurate in all their sections (Kolp et al., 1995). Workers were generally able to understand only around 60% of the information in such sheets (Hazard Communication, 1997; Kolp et al., 1993). The high *cost* of understanding information has discouraged workers from using it to change work habits. Even in cases where workers seemed to comprehend safety information, they used it only in a limited fashion (Phillip et al, 1999). It should be noted that all of the documented cases of the impact of training and disclosure on information occurred within unionized establishments where unions potentially played a key third party role as user intermediaries (Weil 2004; Fagotto and Fung





Medication errors, the most common medical errors, continue to increase rapidly.

**b. Reducing Disruptions Due to Major Plant Closings and Layoffs**

The use of a transparency system to alert workers of impending plant closings has proven ineffective in limiting workers' and communities' dislocation costs. In response to a wave of high-profile plant closings in the mid-1980s, Congress passed the Worker Adjustment and Retraining Notification Act (WARN) in August 1988. WARN requires employers to provide advance notice of plant closures or large scale layoffs to affected workers and local communities. The information is relatively straight-forward: employers must provide affected employees with 60 days notice of a closing involving 50 or more workers at a single workplace and involving one-third of





## IX. Tables

### Table 1

#### **Information Disclosure Systems: An Overview of the U.S. Policies Analyzed in the Paper, Organized by Effectiveness Level**

DISCLOSURE Sys.7METEMC P MICID 1 DC BT1 1 TfTw 0 0123 123 TfTw 0 014 )TJD DC BT1 1 Effectiveness Level

**Table 2**

**Transparency policy evaluation of embeddedness and effectiveness**

Disclosure System	Information	Embeddedness in Users' Decisions	Embeddedness in Disclosers' Decisions	Summary of effects (intended, unintended)	Literature Review
					<p>Comparison of new stock issues in 1923-28 and 1949-55 suggests that mandatory disclosure requirements adopted in 1934 had no important effects on the quality of new securities sold to the public. (Stigler, 1964)</p> <p>Analysis of share prices before and after the 1934 Securities Act suggests that mandated disclosure had no measurable effects on the share prices or on investor risk. (Benston, 1973)</p> <p>Analysis of stock prices on regional exchanges before and after mandatory disclosure finds that variance of returns lessened substantially after disclosure Required, suggesting that investor risk was reduced even though mean returns did not change. (Simon, 1989)</p> <p>Study of financial analysts' data suggests that more informative disclosure policies decrease the dispersion among analyst forecasts, leading to greater accuracy in forecasting. (Lang and Lundholm, 1996)</p>

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**Disclosure  
System**

**Information**



**Disclosure  
System**

**Information**

**Embeddedness  
in Users'  
Decisions**







Disclosure System	Information	Embeddedness in Users' Decisions	Embeddedness in Disclosers' Decisions	Summary of effects (intended, unintended)	Literature Review
Workplace Hazards Disclosure	Hazardous chemical information	Workers understanding UNCLEAR Workers self protection UNCLEAR	Employers switched to less hazardous chemicals YES	<u>INTENDED</u> --	

Disclosure System	Information	Embeddedness in Users' Decisions	Embeddedness in Disclosers' Decisions	Summary of effects (intended, unintended)	Literature Review
Patient Safety Disclosure, New York & Pennsylvania	Ratings of doctors and hospitals for cardiac surgery	WEAK: Patient decisions based on doctor-recommendation, word of mouth, health plan coverage.	VARIABLE: Most doctors and hospitals unaccustomed to tracking safety data and responding to patients' concerns.	<p><u>INTENDED</u></p> <p>-Some evidence that hospitals improved mortality rates after report cards introduced.</p> <p><u>UNINTENDED</u></p> <p>-Some hospitals shifted to treating less sick patients, a possible explanation of improved mortality rates.</p> <p>-Patients continued to select hospitals, doctors with less good safety records.</p>	Analysis of New York hospital data suggested that the dissemination of information on surgery outcomes resulted in an improvement of surgery results

**Disclosure  
System**

**Information**

**Embeddedness  
in Users'  
Decisions**

**Embeddedness  
in Disclosers'  
Decisions**



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... a country-by-country ranking of opacity — the degree to which there is a lack of clear, accurate, easily discernible and... To crea...  
 ... objective variables from 41 sources compared across 238 countries. Each country is ranked on a scale of 0 to 100 upon 6...  
 ... legal system (L), deleterious economic policy (E), inadequate accounting and governance practices (A) and detrimental

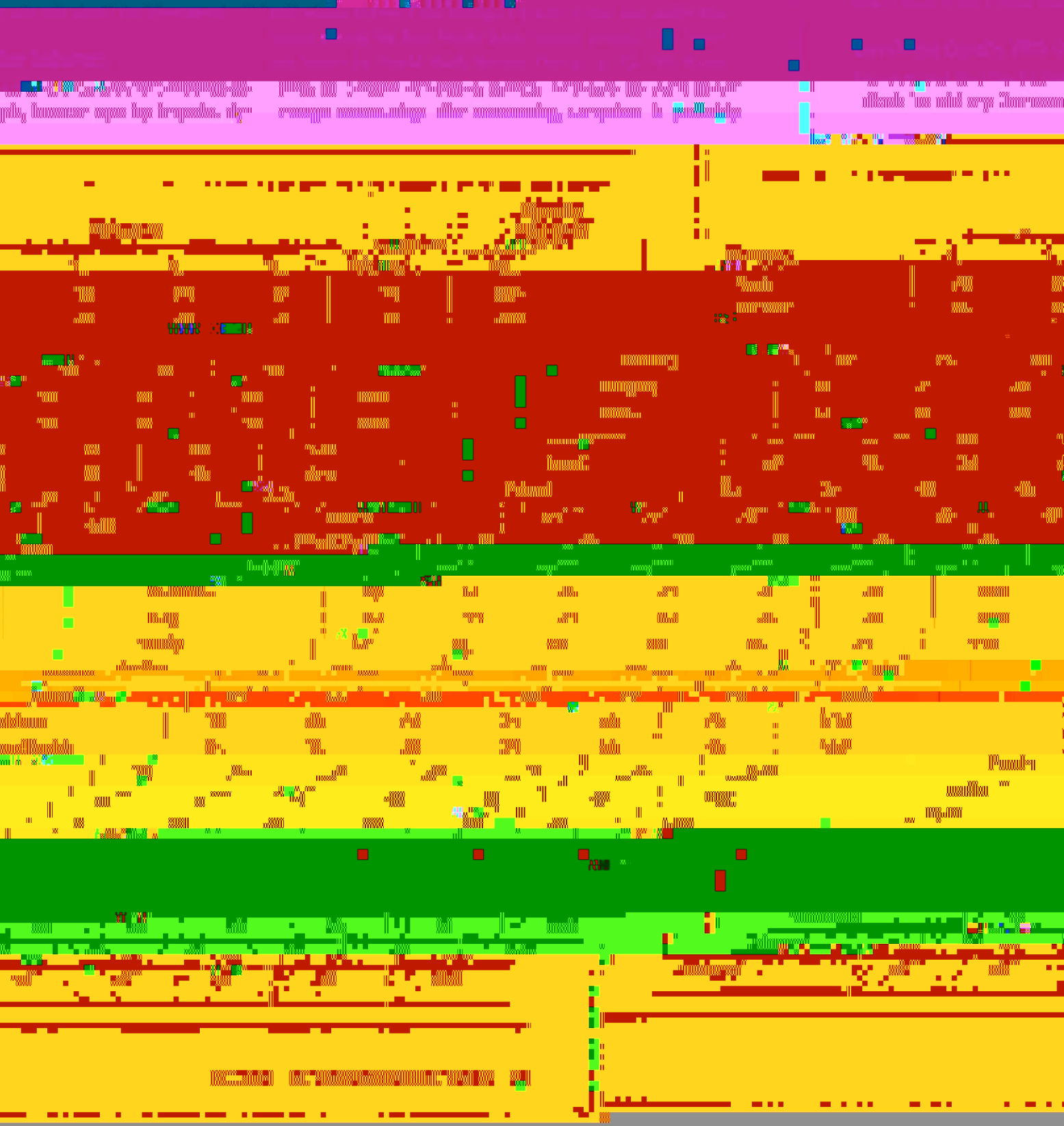


study, the opacity risk premium/discount is calculated by taking the numerical difference in opacity between the subject country and the United States, and multiplying it by 2.12. It means in practice that if a U.S. investor wants to do business in France,

development and efficient functioning of a financial system — the markets as well as business processes and operations — one would expect to find highly opaque countries among the countries that are least developed and *least able to develop*. What's

in Finland, she could actually receive a smaller rate of **income**

to test these relationships.









## The Negative Impact of Opacity

Based upon simple regression analysis, every one-point increase in a

- 1% decrease in a country's net foreign direct investment as a percentage of GDP
  - 0.06-point decrease in its Capital Access Index
  - 4% decrease in its bank assets as a percentage of GDP
  - 0.9% decrease in its stock market capitalization as a percentage of GDP

might be quite different even for countries with the same overall Opacity Index rating. If managers have a choice of where to locate a regional headquarters, for example, they might choose a

plant, they may care more about the corruption subindex. If they are considering a joint venture with another company, the legal subindex will indicate those locales in which the provisions of a joint venture contract will be best enforced.

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## Democracy and the Supply of Transparency\*

B. Pet



Transparency has

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and accountability are shown to have independent e

aggregate conditions are poor, and will instead only punish extractive behavior.

An elected politician may choose to relinqui

where  $\theta_t > 0$  is a random variable, iid each period, and  $x_t$  is chosen by the executive, with larger values of  $x_t$  standing for

commit to a policy choice while imperfectly inf





satisfie

The optimal strategy for the executive then i



clear that voters choose  $\bar{L}(\sigma)$  every period.

**Lemma 1** *For any polity  $\sigma$ , in a  $n$*

As dem



3. As executives trade away opportunities for extraction, we expect to find *corruption is reduced by both democracy*

Transparency International (TI) (see Beck and Keefer (1995))  
drawn from the "International Country Risk Guide" (ICRG), a monthly publica-

tion by the International Country Risk Guide (ICRG) assigned  
government

1  
2  
3

1995) gets a transparency score of 7.2 out of a maximum 7.6, while Cuba gets 2.2. Netherlands gets the maximal score of 7.6. The 47 year tenure is North Korea in 1994.

**TABLE 1 HERE**

**Results**

Model 1: Transparency and Democracy

country at the year in question. Countries more dependent on internat





ments - more transparency is associated with less corruption.

transparency *ceteris paribus*, even though it shrinks with democracy. More

## Appendix

**Lemma 1** *Fo*

by the definition above. Then total differentiation yields  $V_{\tilde{x}} \left( \frac{\partial \tilde{x}}{\partial U} dU \right)$

## Notes

<sup>1</sup>Much of th

economi

<sup>11</sup>Both *Finite Term* and *Political Cohesion* are drawn from the DPI datab

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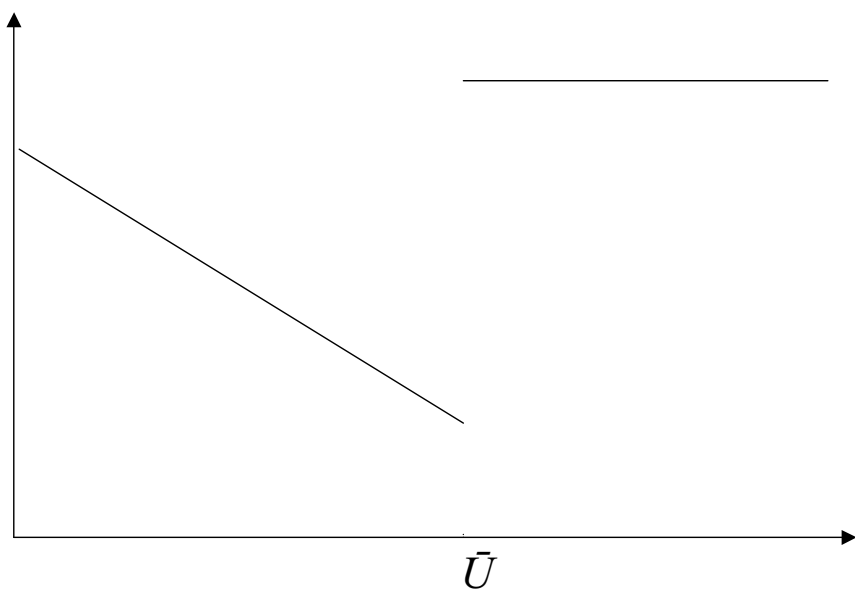
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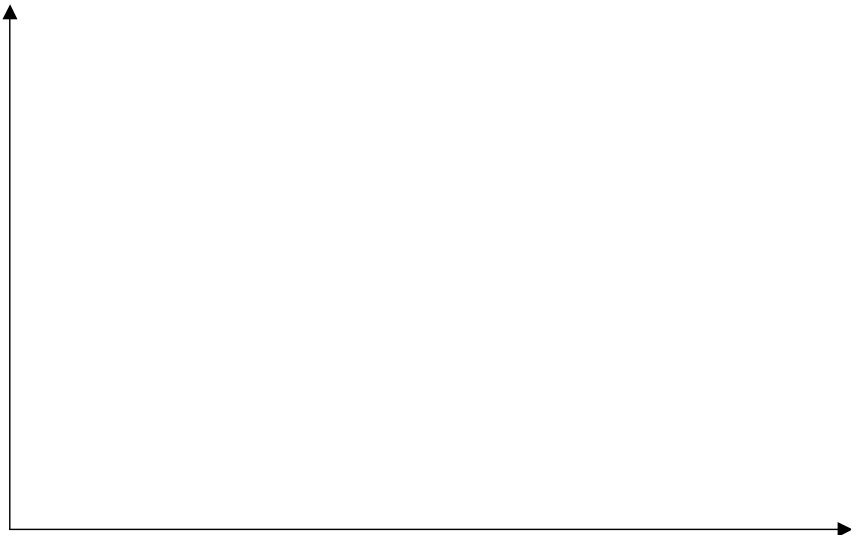
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Table 2: Effects of Polity, GDP, Openness on Transparency in 109 Countries, 1982-1995.

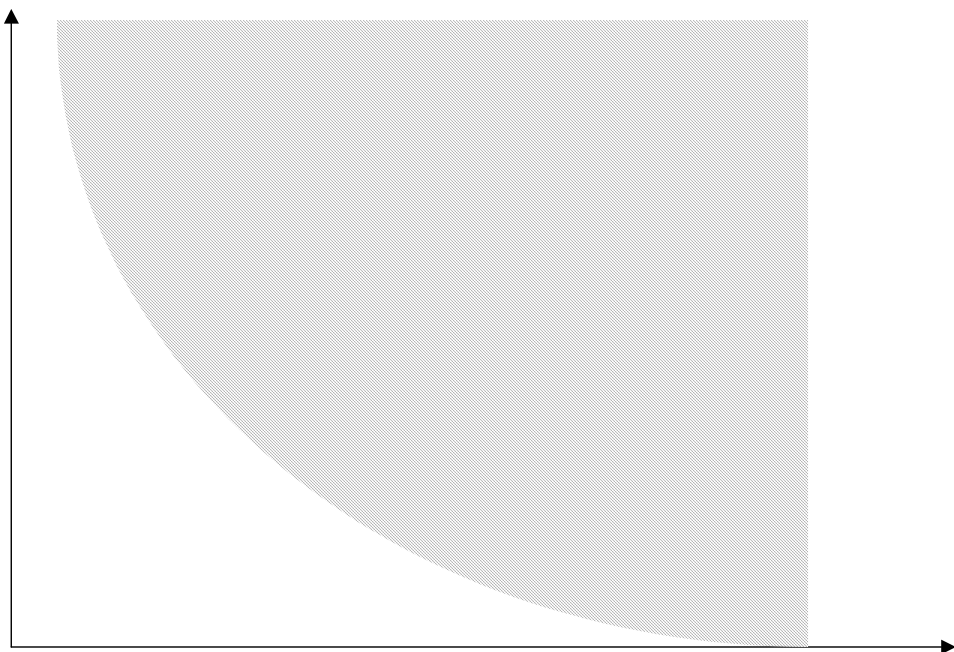
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## Overview

*The significant problems we face today cannot be solved at the same level of thinking we were at when we created them.*

—Albert Einstein

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The history of economic and social development in Latin America is dominated by the search for new paradigms: simplified ways of understanding how the economy and society function that offer governments a variety of policy alternatives. Latin America has ridden the waves of successive paradigms from the State-run, inward-looking development of the postwar era to the macroeconomic discipline and trade liberalization of the Washington Consensus in the 1990s. As with other paradigms, the region's enthusiasm for the Washington Consensus has waned, and it is now in search of a new paradigm that offers better economic results, more stability, and greater equity.

This report questions the logic behind this search. The Fountain of Youite i Q

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actors play in policy outcomes. Instead, the systemic approach simply attempts to understand the constraints and incentives that condition the actions of presidents, legislators, judges, public servants, and other actors that participate in the policymaking process.

Given an emphasis on complex interactions, part of the research agenda behind this report takes a country-centered, historically grounded approach. A first output of that effort is reflected in the Political Institutions, Policymaking Processes, and Policy Outcomes project, conducted under the auspices of the Latin American Research Network of the IDB.<sup>2</sup>

This report takes an additional step in advancing that agenda. It looks deeper into *cross-country comparisons* of the roles and characteristics of the main actors and arenas of the policy process. It develops *new indicators* of policy characteristics and of some properties of political systems. And it develops *comparative cases* in a number of policy areas.

This report should be taken as one stage of a work in progress. It raises more questions than it answers. Unlike previous editions of *Economic and Social Progress in Latin America*, which presented the culmination of years of research, this report is still writing an agenda. Research, analysis, and synthesis will continue. The main messages of the work to date are summarized in the rest of this chapter.

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<sup>2</sup> The results of the project, which benefited from the input of practitioners and academics from several disciplines, are available for examination at [http://www.iadb.org/res/index.cfm?fuseaction=LaResNetwork.StudyView&st\\_id=82](http://www.iadb.org/res/index.cfm?fuseaction=LaResNetwork.StudyView&st_id=82).

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Ten main messages can be extracted from this year's report.

### ***1. Processes matter!***

The process by which policies are discussed, approved, and implemented (the policy-making process) has an important impact on the quality of public policies, including the capacity of countries to provide a stable policy environment, to adapt policies when needed, to implement and enforce policies effectively, and to ensure that policies are adopted in pursuit of the public interest.

### ***2. Beware of universal policy recipes that are supposed to work independently of the time and place in which they are adopted.***

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